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The Expected Effects of the EU Accession on the Banking Sector in Hungary

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Introduction

The purpose of this paper is to describe the position of the Hungarian banking sector from the point of view of the imminent EU enlargement. Our research aims to identify the main macroeconomic effects of the EU accession on the sector, namely the effects on growth and profitability, foreign investments, labour and the market structure. We approached the topic from both the side of legislation, analysing the expected impacts of legal harmonisation between Hungary and the EU, and the side of market structure, focusing on the most probable business and economic courses.

As the first step of our investigation we will overview the recent trends and developments of the EU banking sector. Beyond the analysis of the legislative and macroeconomic tendencies, we will identify the key factors expected to act as the main challenges for the Hungarian banking sector in the course of and after the accession.

Second, we will briefly describe the structure of the Hungarian banking sector concentrating on the main characteristics of the banking system. The macroeconomic point of view received priority but the business perspective was included, as well. We will give a brief summary on the segmentation and specialities of the Hungarian financial intermediaries and the exposure of the domestic market to foreign direct capital.

As one of the most important aspect of the EU accession we will discuss the changes required in legislation. We will see how the process of legal harmonisation led to today's basically EU-conform Hungarian financial legislation, which already includes the widely accepted international standards. However, there is no doubt that the legislative system will have to face substantial challenges even after the accession. The most important challenges will also be demonstrated.

Our ultimate goal will be to understand the macroeconomic effects of the EU accession on the banking sector. The growth, profitability, foreign investments, labour market and market structure effects as most important macroeconomic factors will be investigated in details. We also believe that in understanding the macro level courses, analysis of the market structure changes is inevitable, therefore we will cover the related issues, either.

Although we believe that the discussed topic is of large interest to a broad round of stakeholders, the number of adequate sources to gain information from is very limited. Hence, most of the times we relied on the information provided by the European Central Bank, the European Commission, the National Bank of Hungary (NBH) and the International Monetary Fund (IMF). In addition, official comments and research papers of the NBH formed the basis of some of the sections. In this context we have to emphasise the importance of the NBH papers "A bankrendszer szabályozásának kihívásai" ("Challenges of the Regulation of the Banking System") and "Az EU-csatlakozás várható hatása a magyar bankrendszer fejlődésére" ("Prospective Effects of the EU Accession on the Development of the Hungarian Banking System") both by Balázs Zsámboki, which are widely referenced in the relevant sections of this research.

The Banking Sector of the EU

In this section we will overview and briefly investigate the recent trends of the EU banking sector. The analysis will help to become more familiar with changes of the EU legislation characterising the 1990s, and finally leading to the major restructuring of the European banking sector. The experiences gained during the previous EU enlargements will also be considered, usually taking the example of Spain and Portugal, which countries joined the EU in the mid-1980s.

Afterwards we will describe the ongoing changes in the EU banking sector, primarily focusing on legislative issues and their effects on the market structure. We will also have a closer look at the macroeconomic impacts of the above-mentioned tendencies. Along these we will identify those features and procedures that are expected to provide the main challenges for the Hungarian banking sector during the accession process.

In addition, we will also provide a brief introduction of the effects of the European Monetary Union (EMU) on the European banking sector, analysing the structural changes of the market and macro level impacts, too.

Legislative Changes and the Realignment of the Financial Intermediary Sector in the EU During the 1980s and 1990s

As the most obvious impression, the past decade was characterized by the liberalization and deregulation of the financial markets in the EU. Before these processes, the financial markets of the developed European countries were locally exposed with very limited scope of international or cross-border services. As a consequence of the liberalization and deregulation, major restructuring of the sector took place affecting both the financial and capital markets of European countries.

The first wave of liberalization aimed to boost the international flow of capital by means of eliminating barriers to investments, originating security issuances in foreign countries and liberalising the rules of cross-border transactions and holding of foreign securities. This process took place only gradually, as there were substantial differences between the cultures of local capital markets, furthermore, financial supervision posed as a difficulty for establishing contact between local investors and foreign capital. Even if at slow pace, local financial regulations eventually became more and more standardized. As a side effect of the standardisation, providing cross-border banking and capital market services also became easier. This way, the liberalization of capital flows, which primarily aimed the unbounded cross-border flow of savings, resulted in stronger international competition of financial services across Europe, increased efficiency of the banking and investment service providers and could be regarded as the first step towards the united European market of financial services.

The standardisation of Europe's banking and finance sector's legislation provided advantages for countries with more developed financial sector and solid macroeconomic position, whilst the accessing countries, generally having less advanced banking and financial sector and unstable macroeconomic position, had to face difficulties. As a consequence, during the first few years of the EU membership, the financial sector of less developed new member countries were actually unable to benefit from the free flow of capital among European markets. There was a large pressure to modernise the financial services in order to reach the EU standards and increase their competitiveness on the more or less standardised EU market.

The problems of new member countries were partly caused by the cultural differences between their financial sectors and the European one.

The macroeconomic characteristics like

- high inflation,
- imbalanced state budget,
- high foreign trade deficit and
- vulnerable foreign exchange rate

also acted as prohibiting factors on the way of becoming competitive.

Institutional problems such as

- less developed and less effective financial supervisory system,
- outdated regulation,
- underdeveloped money and capital market infrastructure,
- lower quality of the bank credit portfolio often accompanied by substantial interest rate and foreign exchange gap,
- less skilled management and
- less developed taxation system

made the situation even worse for accessing countries.

It was obvious that in the case of immediate liberalisation of the local markets, the financial infrastructure could not be able to close up to the European markets with substantially higher competitiveness and efficiency and would face a widening gap between the EU average and their sectors.

Several examples, like that of Spain and Portugal joining the EU with less developed financial sector, proved the necessity of full scale restructuring and modernization of the banking and financial sector prior to the liberalization and the deregulation of the money and capital markets. The changes must take place before entering the single market to avoid structural shocks. From a historic point of view the preparatory process consisted of three major steps.

- As the first step, accessing countries abolished the monetary policy of direct interest rate determination. This generally happened already in the 1970s.

- Second, lifting the barriers to investing in foreign securities and issuing corporate and investment securities deregulated the securities markets. This led to a more unbounded international capital flow and increased the exposure of national capital markets to the international tendencies.

- In the third phase, the standardization and modernization of the prudential requirements of the money and capital markets are to be executed, including the abolishment of limitations on the commercial banks' assets and the deregulation of limitations on the ownership structure of financial institutions.

Lessons Learned from the Previous EU Enlargements with Respect to the Banking Sector

Taking the above-described scheme, the liberalization of Hungarian financial markets is at the beginning of the third phase. Even in EU Member States, the process is generally at the end of the third stage as deregulation of the banking system's ownership structure is still under way. Changes in the EU are hindered by the lack of a clear concept regarding the regulation of large transnational financial syndicates and conglomerates, and the policy of defining traditional commercial and investment banking services. The most important step towards deregulation probably was the elimination of barriers faced by foreign banks when entering local markets. In this question the Second Bank Directive of the EU brought substantial changes, by implementing the policy of the Single European Passport. The Single European Passport principle enables all of the banks registered in the EU to provide financial services in any EU Member States without the approval of the local supervising authority and to provide cross-border services within the European Union.

From the point of view of the deregulation process, timing and pace can be considered to be the most important factors. Based on the experiences of Spain, Greece, Portugal and Ireland, the successful liberalization of financial markets requires a stable macroeconomic environment and the structural reform of financial institutions. From this point of view, the most important macroeconomic factors are inflation and the stability of the currency. Liberalization of the currency movements without implementing the above mentioned reforms could lead to strong speculative inflow into the country which may result in increasing consumption and booming household credits concluding higher inflation and a much more vulnerable currency. Several European countries faced speculative capital inflows and outflows even in the second half of the 1990s, which explains why some restrictions sustained on the free capital flows in these countries even until the recent years (see the example of Ireland).

The liberalisation of the local financial markets quickly led to the standardisation of financial services across Europe. The internationalisation resulted in stronger competition and narrowing margins. These were compensated by reducing labour costs and ultimately increasing productivity to maintain profitability.

Experience shows that the financial sectors of countries with more liberalised financial markets and highly standardized regulation (e.g. Germany and the Netherlands) were able to benefit from the single market already at the beginning and did not face substantial banking sector shocks. However, countries with less open and more restricted banking and financial systems (e.g. Italy) had to handle several bank crises after joining the single European market.

The standardised European banking sector could not become a reality without eliminating the regulatory barriers and limitations to the free flow of financial products and services. An indispensable step towards the single market was the introduction of the standardised operating and prudential principles designed by the Basel Committee on Banking Supervision.

Concerning Hungary we can say that the country has already implemented the required deregulation steps and the necessary institutional restructuring. Hungary liberalized its currency and set up a system of financial supervising and insurance institutions that are basically meeting EU standards. Form this point of view, the EU accession will not bring any remarkable novelties in the Hungarian financial intermediary system. However, as the final step of the liberalization and the deregulation, Hungary will have to adopt the Single European Passport principle, which is expected to have substantial influence regarding profitability and productivity of financial intermediaries. The Hungarian regulation is different from the Basel Committee principles at several points, too. Introduction of the new rules is also expected to bring major changes in the Hungarian banking sector.

Current Structural Trends of the Banking Sector of the EU

After the adoption of the Basel Committee principles, due to more effective operations, the European banking sector began to grow at an impressive pace resulting in higher contribution to national GDPs. However, the virtually single market led to stronger competition, which reduced the profitability regarding interest rate margins and fee-type incomes. The banking sector's consolidation coupled with unfavourable macroeconomic environment ended up in several bankruptcies, primarily in the Scandinavian countries. Competition forced several banks to implement cost cutting measures, which led to substantial improvement in labour effectiveness and increased the importance of technological development, opening new channels for banking like Internet and telephone.

Stronger competition imposed challenges regarding effectiveness, productivity and profitability. In reaction to the challenges a wave of mergers emerged among large European financial institutions, in order to exploit synergies from economies of scale and economies of scope. The increasing M&A activity led to high concentration within the EU banking sector. As a result, in most of the EU's national markets, the 5 largest banks control 50-75% of the total market today.

In spite of the deconstruction of market entry barriers within the EU, new entrants in the national markets are very rare. This can partly be explained by the high concentration of national markets and by the high costs of establishing an own infrastructure and retail network. By far, foreign banks gain ground only in corporate banking, which is much less dependent on the quality of the network.

Strong competition and the need for efficiency increased the role of technology in almost every branch of the banking business. As the costs of collecting, handling, storing and processing information fell dramatically, market players became more aware of potential risks then before. This resulted in more transparent pricing, which deteriorated most of the advantages for large banks, which found less competitive advantage in the traditional commercial banking areas, such as lending.

Internationalisation brought new financial activities, like global portfolio and investment management into the focus of large financial institutions. The upswing of portfolio management activities was strengthened by the structural reform of the European pension systems, too, introducing fund-based pension systems instead of the earlier pay-as-you go methods. As more savings are streamed to such financial channels, the weight of deposits within the bank liabilities are decreasing and results in the shift of bank revenues from interest rate to fee type incomes. On the one hand, this only means a restructuring within the banking system, as pension funds and asset management institutions are in the most cases owned by banks. On the other hand, as a consequence of lower amount of deposits held by the commercial banks, the need of securities market financing of the banks increased. This explains the increasing volume of corporate bond issuances of banks within the EU during the past few years.

Effects of the EMU

Introduction of the Euro strengthened further the above-mentioned courses, as the single currency opened new doors for the ongoing internationalisation. Consequently, the consolidation of the European banking sector got a new impetus, thus the M&A activity strengthened within the sector. As consolidation not only affected banks but most of the industries, M&A and buy-out activity also emerged within the region. The high financing needs of such transactions and the higher activity of the banks in these fields led to a more globalised corporate bond and equity market. As the introduction of the euro eliminated the foreign exchange risk, portfolio managers got a much global scope regarding investment opportunities.

With the standardization of prices and fees of the banking services, the incomes from such activities fell substantially. However, from a social point of view, the reduction of fee and interest rate incomes can only be regarded as a redistribution, since other market players saved these amounts.

In spite of all the already completed deregulation and internationalisation and the lack of foreign exchange risk, a standardised or single European banking sector still does not exists regarding traditional commercial banking activities. The bulk (60-64%) of the interbank loans are made between local players and corporate and retail lending is 75-80% exposed to national companies and individuals.

Thus the most important effect of the EU and the EMU by far is the expansion of the security type investments and the portfolio management activity to European level. Leading to a substantial disintermediation this brings the European financial system closer to the US. If we take into account, that the

Hungarian financial system is far lagged behind the EU in this process, we may expect substantial increase in the importance of portfolio management activity in the Hungarian market.

General Characteristics of the Hungarian Banking Sector

In this section the structure of the Hungarian banking sector will be presented. The first part will describe the main characteristics from a macroeconomic point of view, then a brief review of the Hungarian financial intermediary sector will be given from the business perspective, focusing on the segmentation and specialities of financial intermediaries and the exposure of the domestic banking sector to foreign direct capital.

Recent History

During the 1990s, the Hungarian banking system experienced a complete restructuring after the replacement of the old centralized monobank regime by market orientation. As the first step towards the new, market based banking structure, the two-tier banking system was created by establishing several commercial banks besides the former central bank and the state-controlled savings bank.

Structural problems of the former banking system based new two-tier banking system quickly came to the surface.

- First, the newly established commercial banks inherited their portfolio from the former state owned banks along sector segmentation. The specialization of banks on different industries excluded the possibility of any kind of competition among commercial banks.

- Second, major part of the inherited portfolio was full of bad loans, as in the former regime banks were not subject to profit objectives.

- Third, the new commercial banks lacked trained management and proven corporate governance practices. As state-owned companies remained the major shareholders in most of the banks, there was no real pressure on the management to turn the operations around.

- Fourth, there was no adequate legislation controlling the operation of commercial banks, moreover, the bank supervision system was also unable to fully handle the requirements that the regulation of a market and competition based banking and financial structure should meet. Therefore, an overall reform of the Hungarian banking system was unavoidable.

The initial phase of the banking sector's reform was consolidation. As the first step, the state executed a portfolio cleaning in 1992-1993. In the course of the operation, Hungarian banks swapped their non-performing loan portfolio for 20 years maturity government bonds in two rounds. In spite of the non-performing loan swap transaction, the share of non-performing or bad debts within the portfolio of commercial banks continued to increase. The phenomenon can partially be explained by the introduction of international loan classification standards, being much stricter than former ones. The parallel deterioration of debtors' financial position also contributed to the increased bad debts rate.

As consolidation failed to solve several problems, full recapitalisation of the Hungarian banking sector became indispensable. During the process, the capital adequacy ratios of the largest commercial banks were gradually improved to 8%. The next consolidation process came in 1998, when the largest and non-privatised commercial bank suffered heavy losses and had to be recapitalised again. The bank consolidation process cost Hungary more than HUF 1,000 bn, accounting for 13% of the period's average GDP.

After the successful reconstruction and stabilization, the government decided to privatise commercial banks. Privatisation aimed to attract mainly foreign strategic investors in order to get access to the necessary technological background, know-how and management skills besides the required capital. Among the largest commercial banks, only the market leader, former savings bank (with around 29% market share, by that time) was privatised through the stock exchange. The objective of this transaction was to keep the management of the largest bank in Hungarian hands and to give a boost to the Hungarian capital markets.

The structure of the Banking System

After undergoing a substantial structural change in the 1990s, the Hungarian financial system began to develop at a rapid pace. Although the dominance of banks remained unchanged in financial intermediation, several specialized non-bank intermediaries gained ground.

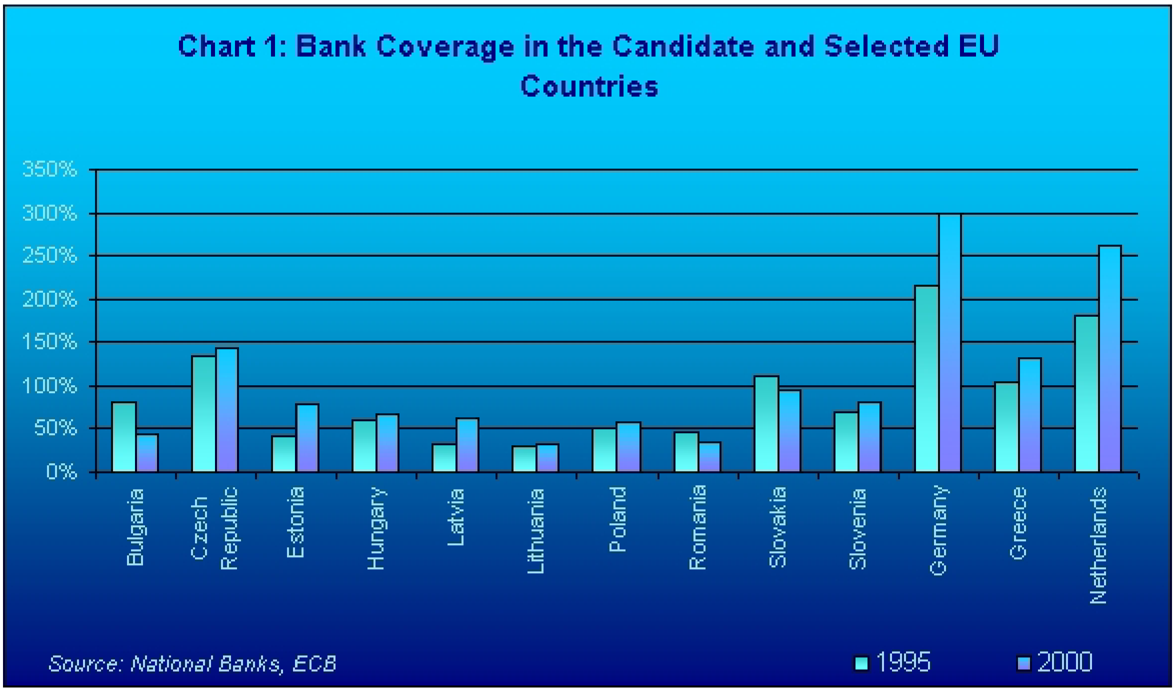
Currently, there are 33 commercial banks and 8 specialized credit institutions operating in Hungary. Besides the banks, there is a high number of savings and credit co-operatives, as well. Although the number of such institutions is approaching 200, their market share only slightly exceeds 5%.

At present, approximately 70-75% of the total Hungarian banking sector is in foreign hands as a result of the above described privatisation process. Of the foreign investors, cca. 75% can be considered to be a strategic investor: these are mainly foreign banks and other financial institutions. The remaining 25%, held by non-Hungarians, is controlled by investment companies. Within the 25-30%, currently in Hungarian hands, the stake of the Hungarian state is near to 20%, mainly consisting of Postabank, Konzumbank (a larger and a smaller Hungarian retail bank) and the Land Credit and Mortgage Bank shares. Based on the above facts, the influence of foreign banks and other institutions on the Hungarian financial system can be considered to be very high. We do not expect further increase in the ownership ratio of foreign institutions, thus we do not expect the Hungarian banking sector to attract substantial additional foreign direct capital after the EU accession.

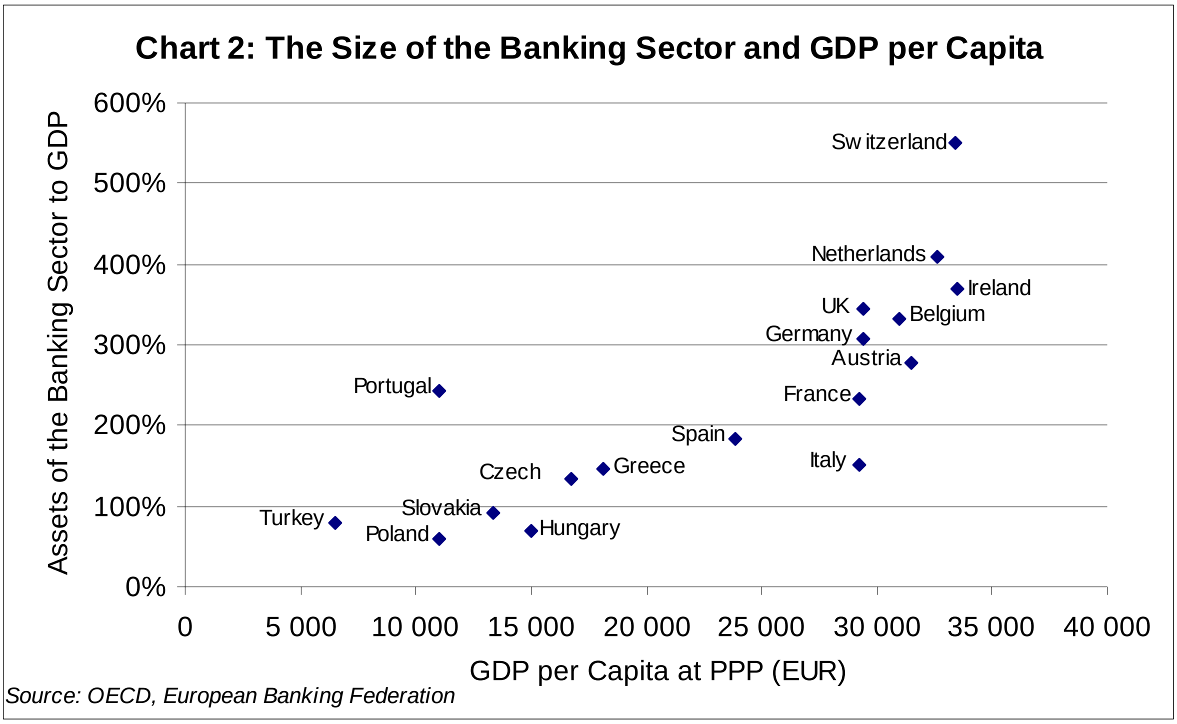
In the short term, the consolidation will bring the boost of M&A activities. Further growth of the foreign direct investment cannot be expected unless structural growth of the banking sector begins, thus the depth of financial intermediation increases.

Banks in the Financial Intermediation

The depth of the Hungarian financial intermediation is low, the total assets of the banking sector accounts for only 68.2% of the GDP. For comparison, the size of the banking sector to the GDP is generally spreading between 100% and 300% in the EU countries. This may suggest that the banking sector has substantial growth potential in Hungary.



The relatively small size of the banking sector to the GDP is partly explainable by the underdeveloped economy. A research by PriceWaterhouseCoopers showed that in the EU countries 1% increase in the GDP/capita ratio statistically results in a 1 percentage point increase in the ratio of total assets of the banking sector to the GDP. This means, that the growth rate of the banking sector generally outpaces the growth of the whole economy, and so the depth of the financial intermediation is lower in less developed countries. Based on this assumptions Hungary's expected dynamic economic growth induced by convergence to the EU is expected to result in an even more dynamic expansion of the banking sector.



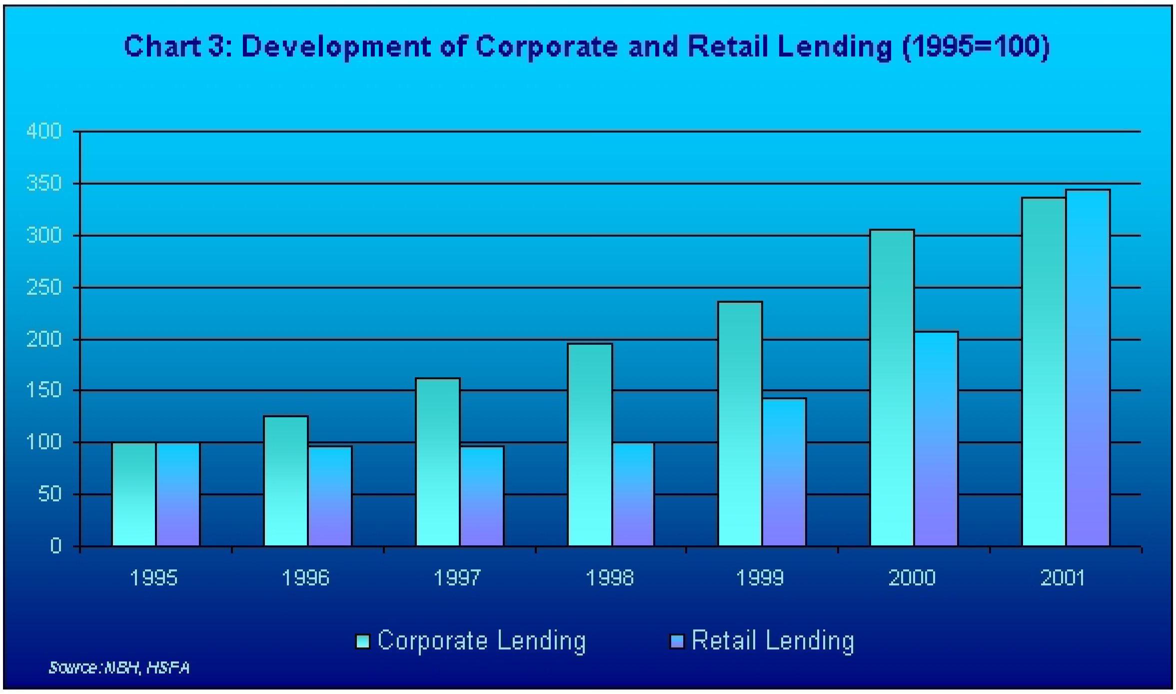
However, there is no doubt that the Hungarian banking sector's development will be affected by several other macroeconomic factors than solely the economic growth. Based on research results by Jaffee and

Levonian, the growth rate of the banking sector in CEE countires is positively correlated with the total size of the banking sector's foreign loans and with the savings rate. Based on these assumptions Jaffe and Levonian estimated the equilibrium level depth of Hungarian financial intermediation to be around 180%. This means that the long term size of the banking sector to the GDP is 2.5 times higher than now. They estimated the equilibrium number of commercial banks to be only around 1.5 times higher than the current number. This suggests that the Hungarian market is "overbanked" at the moment and in the future, the increase in the number of banks will not keep pace with the development of the banking sector assets.

The growth rate of the aggregated balance sheet total of the Hungarian banks slowed down to 7.4% y/y in 2002 after 13.2% y/y in 2001. This reflects the general slowdown in the economic growth and the beginning consolidation of the market.

In 2001 the ratio of aggregated loans to total assets was around 52.9%, resulting in loans to GDP ratio of 30.4%. These ratios are fairly below the EU level, indicating sluggish lending activity. The lending activity of the Hungarian banking sector is low not only compared to the EU but compared to other candidate countries, as well. Change in this situation can be brought only by the continuing fall in inflation and interest rates, and the relatively high economic growth rate.

The growth rate of total lending to the private sector slowed down to 17.0% y/y in 2001 after 31.5% y/y in 2000. Accordingly, a significant change was observable in the structure of the lending activities as growth rate of corporate loans fell substantially below the growth rate of loans to households, in spite of the fact that corporate loans are accounting for the vast majority (80%) of the total lending. In 2001 the total amount of corporate sector loans rose by 10.1% y/y, meaning a significant slowdown compared to the 29.8% y/y growth rate registered a year earlier. The growth rate of retail loans was 66.8% y/y in 2001 and 45.1% y/y, a year before. On the basis of the very high margins of the retail products, there is more room for increasing competition in this segment than in the corporate one. Hence, for the next few years the growth rate of retail loans is expected to remain above the growth rate of corporate loans.



As the Hungarian economic growth is largely driven by exports, the exposure of Hungarian corporations to foreign exchange risk increased significantly in the last few years. Around 1995 only 12% of the corporate loans were denominated in foreign currencies. Now this ratio is around 35%. As a consequence of the opening of the Forint's fluctuation band in the middle of 2000, further expansion of foreign currency denominated debt is expected, as companies with substantial Euro-denominated revenues will increase Euro-denominated financing to hedge currency risk.

Within the retail sector the most noticeable change of the recent years was the increase of mortgage loans. The boom of the mortgage loan market was basically generated by the government financed incentive package, providing substantial interest rate subsidies. Although this market segment is relatively small at the moment (representing only 2.7% of the total assets of the banking sector), it is expected to keep growing at a very high pace in the next few years.

Table 1: Assets and Liabilities of the banking sector

Assets			
	1999	2000	2001
Public sector	966	1,122	1,328
Corporate sector*	2,379	3,087	3,399
Households*	295	428	714
Non-residents	888	768	1,209
Central bank and financial institutions	2,335	2,495	2,237
Shares and other assets	484	524	617
Total assets	7,348	8,427	9,505

Liabilities			
	1999	2000	2001
Public sector	227	2641	309
Corporate sector*	1,292	1,523	1,753
Households*	2,406	2,713	3,173
Non-residents	1,398	1,596	1,668
Central bank and financial institutions	689	834	899
Own funds	632	782	956
Subordinated debt	146	149	135
Other liabilities	489	516	579
Total liabilities	7,348	8,427	9,505

Loans and deposits by individual enterpreneurs are classified as corporate until 05/2001 and as households since 06/2001

Source: NBH

Stability

Hungarian banks can be considered to be generally well capitalized, with average capital adequacy ratio around 15.6%, which is well above the legally required 8% and the EU average, too. The capital structure of the banking system is dominated by equity together with a lower amount of sub-ordinated loans, representing less than 14% of the total funding of the system.

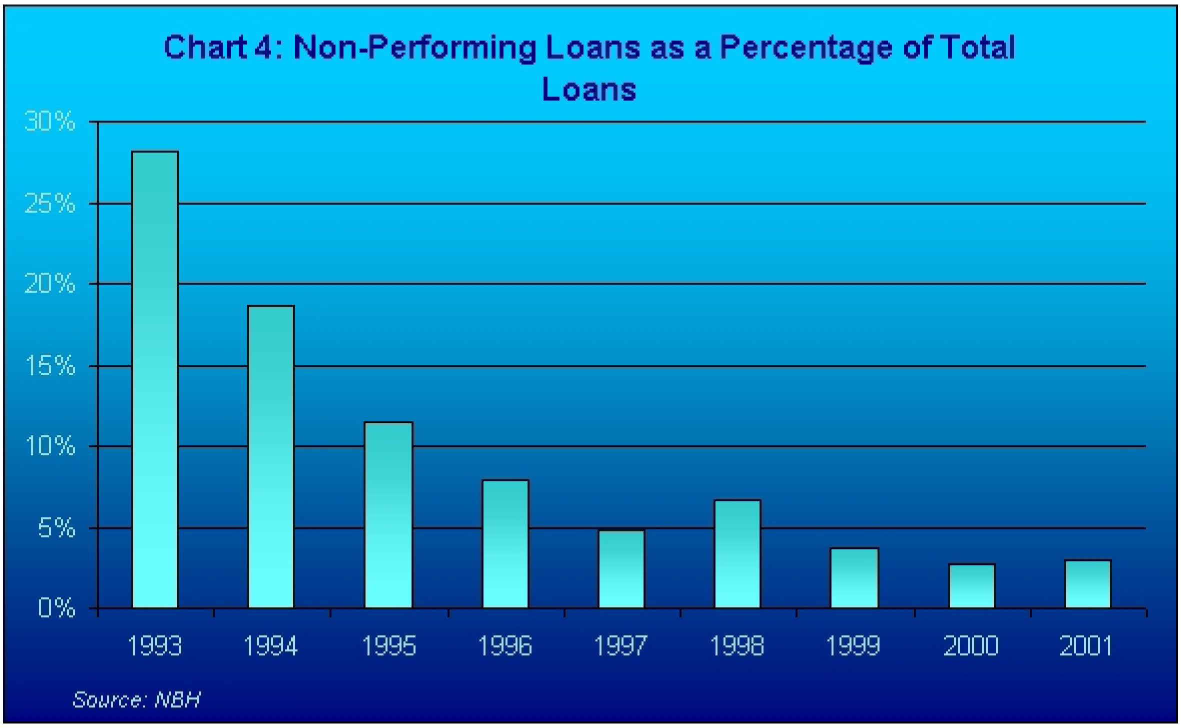
Table 2: Capital Position of the Hungarian Banking Sector

	1999	2000	2001
Share capital	354,467	396,79	419,165
Subordinated debt included in regulatory capital	124,715	127,322	117,215
Regulatory capital	589,639	741,131	797,091
Capital adequacy ratio (%)	15.00	15.21	14.15
Leverage	12	11	10

Source: NBH

The very high growth rate of lending activities represents a major risk for the Hungarian banking sector. The increase in bank deposits lags fairly behind the increase of credits, therefore banks are restructuring their assets. They are decreasing their central bank deposits and government securities holdings in order to manage the expansion of their credit portfolio, which means higher risk for the banks' operation.

Accordingly, the banking sector experiences a shift towards longer term assets. The higher risk resulting from the longer duration of bank assets is partially counterbalanced by the growing ratio of long term deposits.



The Hungarian banking sector's loan portfolio can be considered to be in fairly good shape from credit risk perspectives. In 2001, the ratio of risk-weighted qualified assets was 1.75%, being practically unchanged compared to 1.53% in 2000 and 2.24% in 1999. The unweighted ratio of qualified claims was 11.94% to total claims in 2001, showing a slight increase compared to 7.76% in 2000 and 8.86% in 1999. The ratio of bad loans to total loans was at 0.77% in 2001, which can also be regarded to be stable compared to 0.83% and 1.21% in 2000 and 1999, respectively. Based on these numbers, the portfolio quality of Hungarian banks does not bear substantial short-term risks.

Table 3: Portfolio Quality of the Banking Sector Loans

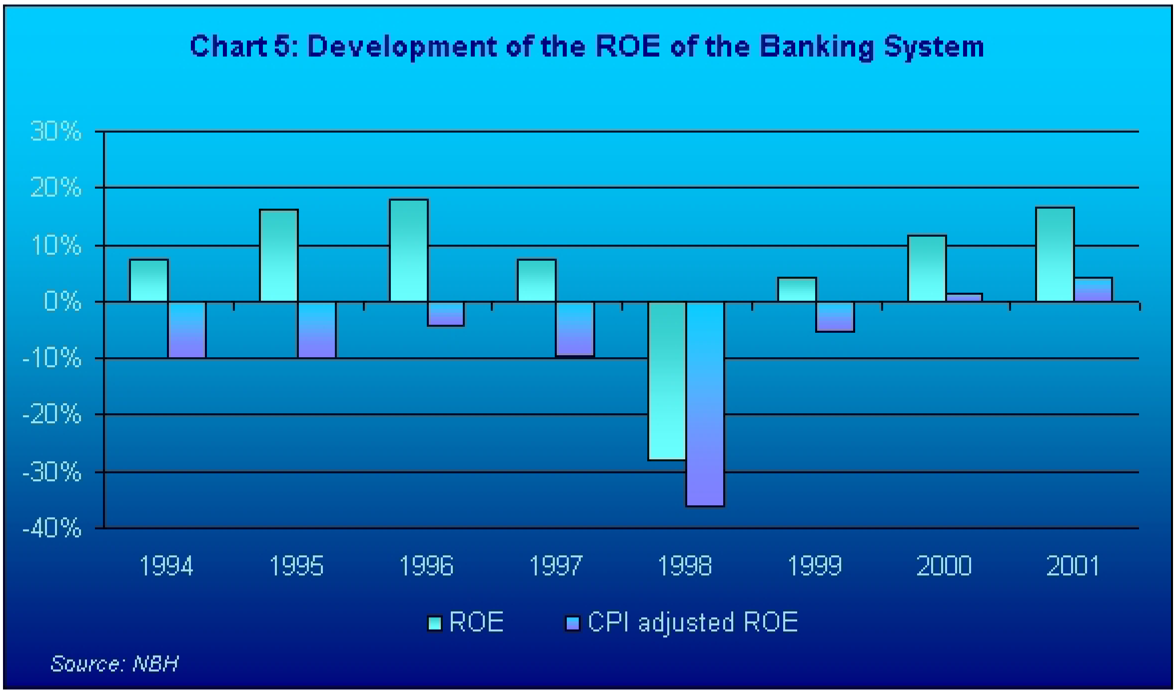
	1999		2000		2001	
	HUF bn	%	HUF bn	%	HUF bn	%
Problem free	7,122,667	91.1	8,383,001	91.5	10,283,767	88.1
To be watched	405,754	5.2	522,283	5.7	1,047,467	9.0
Substandard	72,259	0.9	79,472	0.9	176,713	1.5
Doubtful	119,103	1.5	97,224	1.1	80,368	0.7
Bad	94,919	1.2	76,267	0.8	90,209	0.8
Ratio of qualified claims (%)	8.86		7.76		11.94	
Risk-weighted qualified claims (%)	2.24		1.53		1.75	

Source: NBH

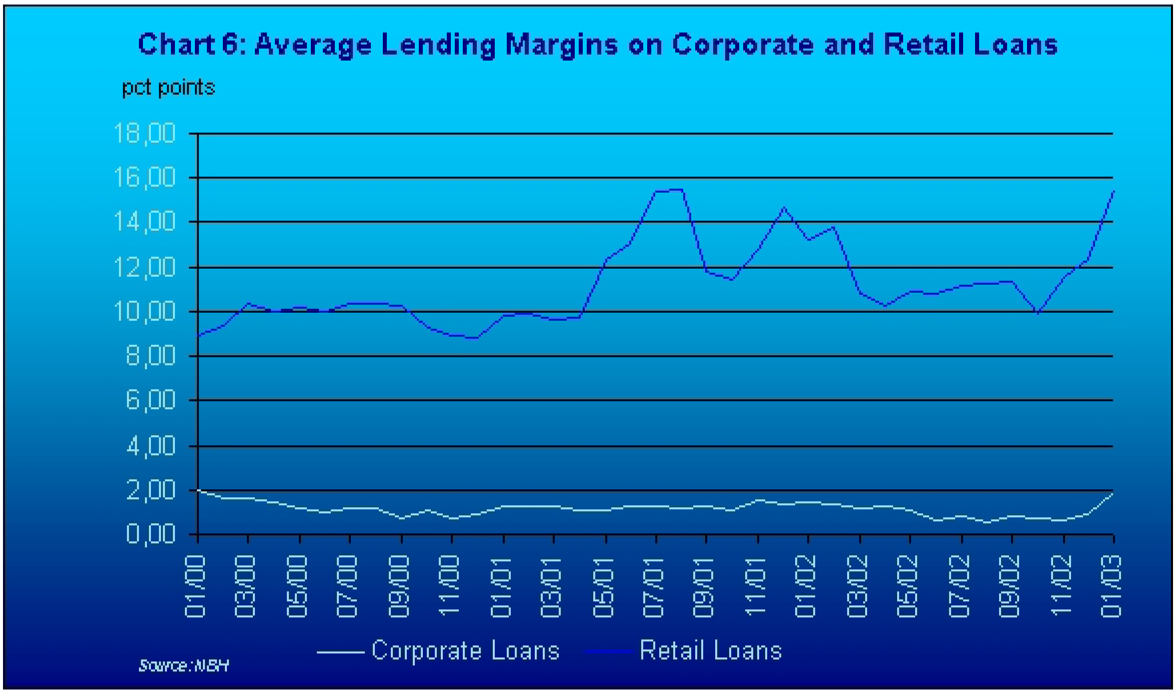
Profitability

The Hungarian banking made HUF 164 bn pre-tax profits in 2001, exceeding the previous year's figure by 50%. The most important factor behind the growth is the increasing lending activity of the Hungarian banking sector. In addition, considerable increase in fee and commission incomes accompanied the tendency, which indicates the strengthening of non-borrowing activities, as well. A slight increase in cost-efficiency could also be observed during the past few years.

Return on equity (ROE) figures of the banking sector improved at an impressive pace. ROE was very low at 4.1% in 1999 after the Russian crisis, then it rose to 11.6% in 2000 and to 16.6% in 2001. Increasing ROE figures of the past few years were the result of the rapid growth of earnings on interest bearing assets. As growth of loans outpaced the expansion of deposits, banks substituted their risk free assets (government securities and central bank deposits) with higher return customer credits. Stronger exposure to interest rate incomes can be felt from the increasing importance of interest type revenues, accounting for 61% of total revenues in 2001 compared to 54% in 2000.



Another important factor regarding the increasing profitability of the Hungarian banking system is that the narrowing banking spreads stopped in 2001. However, there is a noticeable difference between corporate and retail loans. In 2002 corporate loans were running with an average spread of 3 percentage points, while retail loans beared as high as 12 percentage points spreads. With the expected intensification of competition in the retail sector, these exceptionally high margins on retail lending are likely to go down in the next years. Additionally, the EU convergence driven general decrease in interest rate levels also let interest rate margins downwards in the case of corporate and retail banking, too.



Growth of operating costs did not exceeded the inflation, mainly thanks to the increasing labour productivity of the banking sector. As major technological development projects were completed already in the previous years, 2001 faced a relative dip in IT expenditures. However, as the general level of technical equipment is still substantially lagging behind the EU standards, further investments are needed on the fields of IT and general infrastructure. Thus we expect technological expenditures to increase in the next few years.

In the medium term, the rise of labour-related expenses is expected to remain under control, as strict human resources management is required to approach the much more competitive EU market. Therefore, the Hungarian banks will be forced to improve labour efficiency further.

Table 4: Income statement of the Hungarian banking sector

	Assets		
	1999	2000	2001
Net interest income	276	310	363.3
Dividends received	12	6.7	4.1
Change in provisions	-3.2	-1.7	-28.3
Net commissions and fees	60	78	102.2
Profit from financial transactions	7	55	65.1
Other profits/losses	-47	-49.8	-32.6
Gross profit from financial and investment services	306	400.2	473.9
Costs of banking operations	271	294.1	327
Profit before taxes	36	96.7	159
After-tax profit	24	77	133,7
Retained Earnings	3	53	131

Source: NBH

Liquidity

Due to the much higher expansion rate of banking loans compared to that of banking deposits, the loan to deposit ratio of the Hungarian banking system, which is regarded as one of the most important liquidity indicators, increased substantially over the past few years to around 82.5%. This resulted partly from the fact that banks with customer credit/customer deposit ratio over 100% increased their market share from 37.2% in 2000 to 46.4% in 2001.

In the past two years, the liquidity ratio of banks remained sufficiently high around 31%, while the share of money market liabilities within external liabilities, considered to be the most volatile, decreased to an extremely low level of 6.7%.

Expected Trends of the Hungarian banking Sector in the View of the EU accession

The aim of the section is to describe the state of the Hungarian retail and corporate banking sector in the light of the EU accession. When reviewing the trends expected to evolve, we will concentrate on the possible effects of the EU accession.

The last few years brought several changes in the Hungarian legislation of financial institutions, influencing the banking sector, as well. The main drive behind the reform was the required legal harmonisation. As a result, the Hungarian legislation became basically EU conform and also includes the widely accepted international standards. Some of the rules will have to be applied only on the internal EU market. The legislation already covers these points, too, however they will become effective only on the date of Hungary's accession.

In the second part of this section we will take into account the legislative changes that will affect the Hungarian banking system after joining the EU. We will analyse the effect of such changes in the Hungarian banking sector and will evaluate the extent they are expected to alter the operation of the domestic financial institutions.

Trends in the Hungarian Corporate Banking

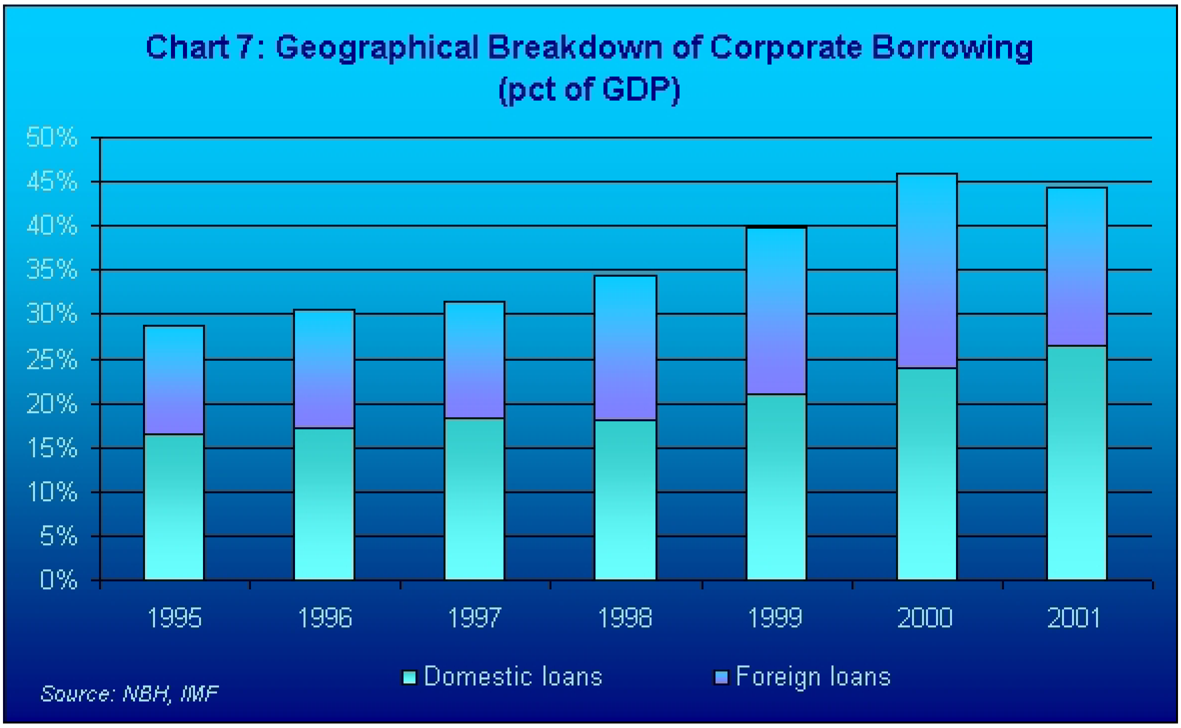
Trends of the EU

Taking the general EU trends into consideration, financing of the corporate sector is at lions' share done by banks. The expansion of bank loans reached 7-8% in 1998-1999, and accelerated further in 2000. This was fuelled mainly by the decrease of interest rates on bank loans and the increasing financial needs of corporate transactions. Among these transactions, the most remarkable change was originated by the mergers and acquisitions activity and infrastructure projects with high financing needs besides the general upswing in the European economy. The intensity of corporate bond issuance also strengthened in the past few years, tripling between 1997 and 1999. Parallel to the expansion of demand for corporate loans, substantial growth was experienced in equity security issuances, which had been doubled between 1997 and 1998. There was also a remarkable change in the structure of the equity markets, as several new, higher risk markets appeared and performed well in the last years of the 1990s.

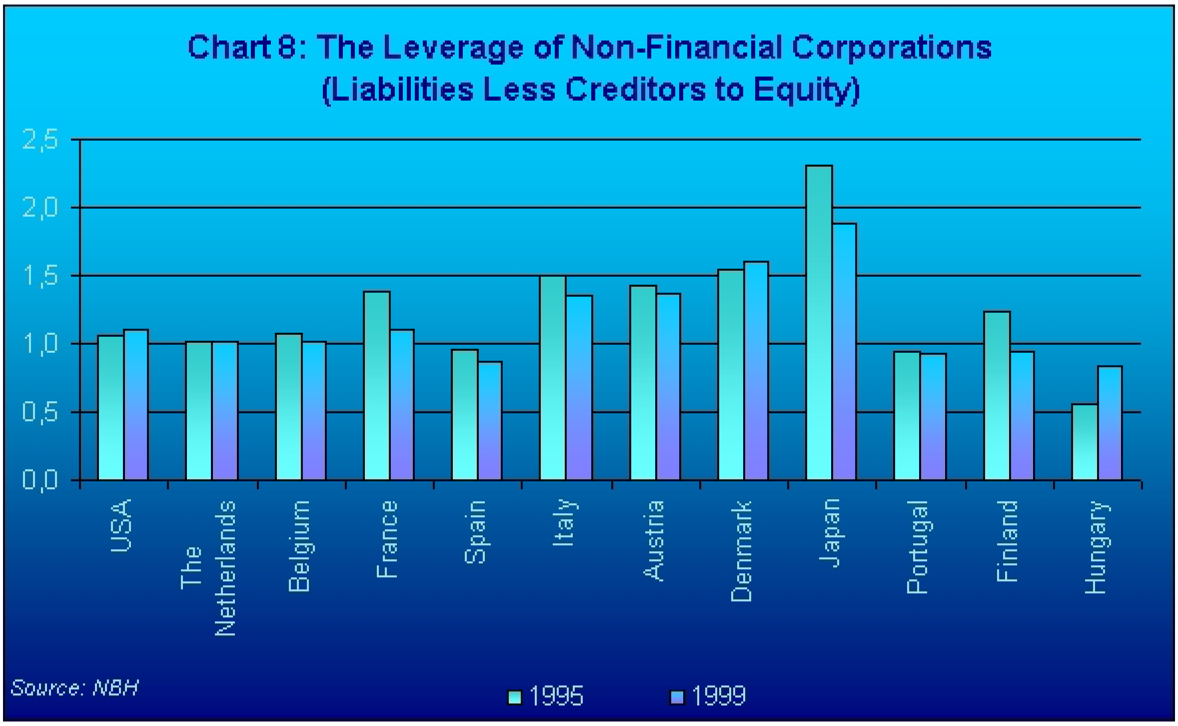
The increasing financial needs of the larger European corporations acted as stimulus rather on the capital markets than on banks, a noticeable change could be observed in the sector of traditional banks, since their activity turned more and more towards investment banking activities instead of traditional banking tasks. This was reflected in the increase of the non-interest type revenues (fee revenues) and extra-balance sheet activities, like asset securitisation, too.

Expected Trends in Hungary

The Hungarian financial intermediation system can be considered to be a bank based financial system, as the role of the capital markets is tiny in the financing of the corporate sector compared to the role of banks. The GDP-proportional capital markets capitalization is running only around 50% of the EMU average, which is considered to be low compared to the US. The corporate bond market, as the main substitute for the banking products, is even less developed. The main reason of the lagged position of the capital markets is that the size of the Hungarian market does not even enable the larger corporations to originate capital market transactions. In this field we expect substantial changes from the EU, since there will be a larger access to capital markets, and with approaching the EMU the currency risk will be decreasing as well.



The leverage of the Hungarian corporations increased substantially in the second half of the 1990s and now converges to the lower edge of the EU level. However, the financing role of Hungarian banks is relatively low. The reason behind is the fact that foreign international companies, which played a major role in the boost of the Hungarian economy, financed their transactions from parent company sources. Therefore, instead of Hungarian banks foreign institutions were involved indirectly.



Taking into account the good prospects of the Hungarian economy, we expect the growth of the leverage of Hungarian companies to continue. Along with this, the importance of bank financing for Hungarian companies is likely to increase. Spain and Portugal experienced the same in the course of their accession to the European Community. In these countries, the post-accession era brought the substitution of loans from the parent company or other foreign loans with domestic loans. In Hungary, the change is expected to be fuelled by the improved possibilities of syndicated financing and the decreasing costs of mandatory reserves, coming along the EU accession. The Single European Passport principle, which enables foreign banks to freely open branches in Hungary, represents potential risk for this process, as existing parent company loans will be more easily managed through local branches of the foreign parent company's banks. We feel, however, that Hungary will be fairly less sensitive to the last effect concerning corporate banking, as the importance of local branches is very low considering these business lines. Overall, we expect domestic corporate loans to gain ground against foreign loans due to the EU accession.

One of the most sensitive questions regarding the tendencies of Hungarian corporate banking after joining the EU is the financing of small and medium enterprises. The financing of small and medium enterprises is done by banks worldwide, the role of capital markets is insignificant in this field. EU experiences show that SMEs have much less sophisticated banking relationships than the larger companies, which is similar in Hungary. Considering the current schemes of SME financing, the same forms are existing in Hungary as in the EU: the dominance of overdraft (working capital related), general-purpose loan and leasing financing can be observed. The SMEs are short of bank sources necessary to finance their growth. This is reflected by the fact that the proportion of SME loans to total loans is substantially below the contribution of such enterprises to the GDP formation. (While SMEs contributed to the GDP by 45%, their total share within the corporate loans of the Hungarian banks was only 35%.)

The same tendencies of SME financing exist in the EU, as well. The reason for this is the same as in the case of Hungary, namely the low ability of such enterprises to provide the necessary coverage for bank loans. We have to mention that the problem is much smaller in the EU, as the more sophisticated practice and models enable financial institutions to create products especially for the needs of SMEs, resulting in more bank financing. With the accession to the EU, the increasing competition and the more direct access to such practices and methods are likely to increase the share of banks in SME financing. Thus, as a result of the EU accession we expect substantial changes in this field. At the same time the Hungarian economic policy – recognising the EU tendencies – is providing increasing support for such courses.

Another source of SME financing could be provided by venture capital companies. However, as a consequence of the relatively underdeveloped capital market structure (see above), venture capital financing lags far behind the EU level, which is still substantially below the US level. The total venture capital and private equity investment figure is around 38% to the GPD in the EU, whilst it is running around 12% in Hungary. Accordingly, the solution for the problem of SME financing is not expected to come from the venture capital finds. It will be rather the task of the Hungarian banking sector to provide sufficient solutions for this special but very important sector. The EU accession again is expected to bring substantial changes here. Banks with good relations to SMEs and sufficient products may gain competitive advantage around the years of EU accession if acting quickly in this field.

Trends in retail banking in Hungary

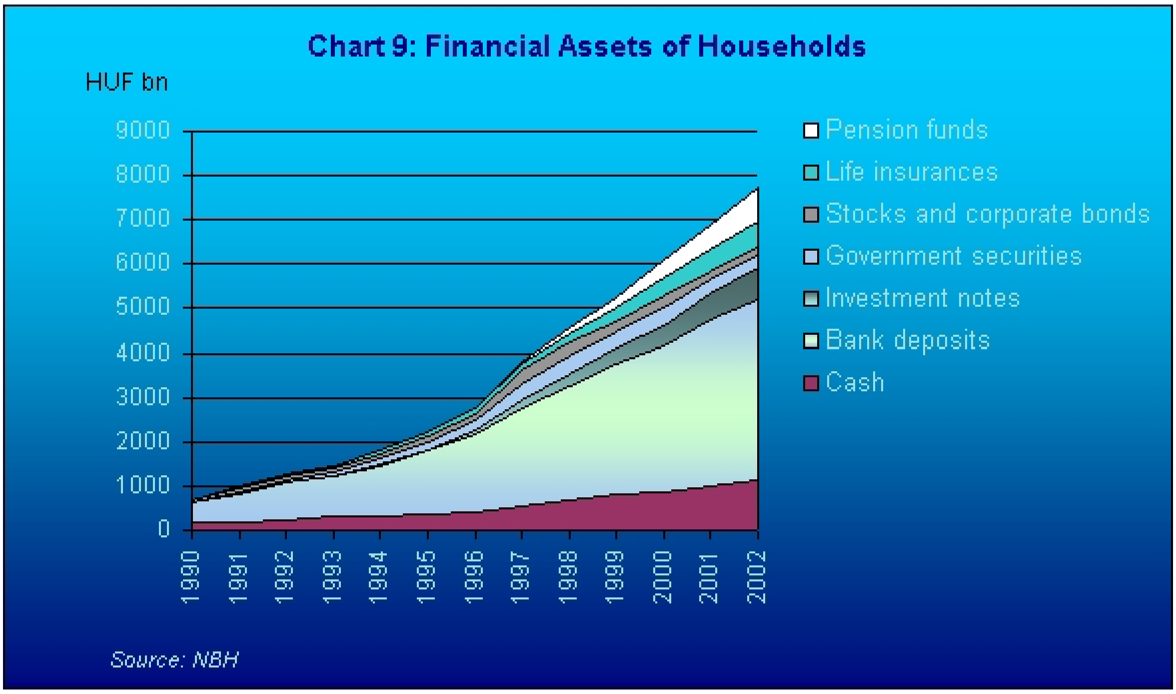
Trends of the EU

The last few years brought favourable changes concerning the macroeconomic environment relevant to retail banking. For a number of reasons the household consumption boosted which was accompanied by decreasing savings rate and increasing indebtness. Some of the most important macroeconomic factors behind were the continuously booming economy, the positive expectations of households regarding the general economic environment, and the constantly and substantially falling inflation accompanied by continuously decreasing interest rate. These, together with the liberalization and the modernisation of the financial intermediary sector, led to softening budget constraints. It is important to understand that the above described changes stemmed from the structural change in the economy and were the natural consequence of the transition period's end from a macroeconomic point of view. Thus they did not simply result from a temporary or cyclical economic upswing.

In spite of the above mentioned structural changes, the level of indebtness of the Hungarian households is still significantly below the respective EU level. In the EU, the indebtness of the household sector, measured by the level of financial debt in the percentage of total disposable income is around 40-130%. The same ratio in Hungary is only slightly above 10%. Another measurement number, the amount of bank loans to households compared to the GDP is running at around 46% of the GDP in the EU. This ratio is substantially lower in the case of Hungary, around 6%. Considering the structure of the credit portfolio of banks in the EU and in Hungary, the ratio of household bank loans to corporate bank loans is above 100% in the EU and only 22% in Hungary showing substantially lower exposure of the banking sector to the retail business than the exposure to the corporate one.

The above numbers suggest that there exists substantial potential for retail lending assuming convergence to the EU. Considering the structure of household lending in the EU and in Hungary another significant difference can be explored. While in the EU the housing loans are accounting for 67% of the total household loans, in Hungary this ratio is only around 37%. Thus we might expect the development of housing loans to become the main engine of the expansion of the household loan portfolio.

Considering the passive side of the banking sector, the differences are not so significant. While in the EU household deposits of the banking sector account for 80% of total deposits, in Hungary the ratio is running around 67%. This suggests that the expansion of household deposits is expected to be much more moderate in Hungary after the EU accession, than in the case of household debt. However, it is expected that the structure of household debt will be shifted towards capital market instruments, like pension savings and investment funds.



Taking into account that the Hungarian financial sector will be integrated into the EU's financial sector in a substantially more advanced position than it happened in the case of Spain and Portugal, which countries liberalized and modernized their financial system at the time of the EU accession and not prior to it, we feel that the expected changes in the household banking will be much more moderate. This will be felt in the more gradual increase of the indebtness of the households and the more moderate change their debt-bearing propensity. The more prudent borrowing practice of the Hungarian banking sector also points to this direction.

Concerning the long term structural outlook of the Hungarian retail sector it is important to emphasize that the adoption of the general EU trend of turning towards advanced techniques in the case of retail banking may also have significant effect on the development of this banking business branch. The IT development may open new sales channels and may help the traditional retail banking activity to get closer to the EU quality standards.

Although, the real expansion of cross-border retail services is not observable even in the EU, some early sings of it are already present. On the whole, increasing competition in the region concerning retail banking services can not be excluded. This increasing competition could conclude in further consolidation, decreasing profit and increase of operating risk. In this case only more efficient supervision of the operation of banks and more advanced and prudential capital adequacy techniques are needed in order to turn the stronger competition into higher efficiency instead of instability. This could provide substantial challenges for the Hungarian banking sector.

Retail Borrowing

As it was shown earlier, the main engine of the retail borrowing could be the surging of the housing loans. In Hungary the mortgage or general housing lending is only in an early phase and substantial growth of the sector is expected. However, at the moment there are several obstacles in the way of boosting housing and mortgage lending. The most important hindering factors are the granularity of the Hungarian lands and the relatively low price level of property. The EU accession is expected to bring significant changes in both fields partially by the expected positive effect on the modernisation of the agriculture and the accelerating convergence of property prices. The growth of housing loans portfolio is expected to be boosted by the factor that the average quality of a Hungarian home is substantially below the EU average, which is expected to maintain the strong demand for housing loans with modernisation purposes.

Increasing mortgage loans could result in higher capital market share of mortgage notes. In the EU the market share of mortgage notes or mortgage bond within the total capital market portfolio is around 17%, while the same figure in Hungary is around 0.3%, which suggests that there is substantial potential for this instrument.

If we assume a dynamic increase in the retail loans, it will be more and more necessary to build up an eligible credit-risk reference service for retail clients, similar to the one operating in the EU. A bank-independent credit-risk reference service, which enables financial institutions to identify the special risk factors they might take when providing loans to retail customers on a historic basis, can be considered as a necessary condition for every developed banking system with substantial exposure to the retail sector. However, developing of such a credit reference service is hindered by several legal obstacles related to the Hungarian legislation. The harmonization of the Hungarian legislation from this point of view will be a must around the time of the EU accession in order to release the brakes ahead of the expansion of the retail banking.

Savings and Transaction Services

Considering savings and money management services we do not expect significant changes caused by the EU accession. Because of the increasing income of households the amount of bank deposits is expected to increase at the pace of the general economic growth. One of the few significant changes will be the raise of the deposit insurance limits. Solely this factor, however, will not be enough to increase the demand for bank deposits.

In the case of banking cards the Hungarian market is more or less saturated with the lions' share of the population with active banking relationship. Approximately 50% of the whole population is owning some kind of deposit cards. In the near future and with the EU accession only the quality of the service and the number of sales points accepting such cards is expected to be improved. Along with international tendencies the expansion of the safer but more expensive chip cards are expected to change the current dominance of magnetic field cards in the medium run.

Legislation

The general liberalization and deregulation, which characterized the European legal system recently, was mainly resulted from the appearance of several new financial institutions, products and services on the financial markets. A similar process took place in Hungary, too, but with a substantial lag compared to the European countries.

Liberalization and deregulation, the European financial markets led to higher competition in the national markets. The increased competition often endangered the stability of less effective banks and financial institutions, even leading to several crises. The increasing number of bankruptcies made clear the necessity of an integrated legislative system which eliminates the substantial differences between the traditional legislative and supervisory systems of the European countries. This was the main reason behind the principles designed by the European Union's Basel Bank Supervisory Committee, which made the national prudential requirements and market entrance requirements standard for all of the member countries. This way the Basel Bank Supervisory principles provided the opportunity to create a single market within the EU with the same propositions for financial institutions operating in any member countries.

The global competition within the EU led to higher quality services and enabled the survived financial institutions to exploit the benefits of both economy of scale and economy of scope better. In spite of the opportunities of the global operation, we can state that the EU's financial sector is still segmented by countries. Substantial internationalisation can be observed only in the corporate banking sector, which does not need the previous establishment of an expensive sales network. On the other hand, the retail banking sector lacks signs of internationalisation by far, primarily due to the higher importance of regional and cultural characteristics and the very expensive sales channels.

In the process toward a standardised European financial sector the Second Bank Directive of the Basel Committee brought another impetus with the introduction of the principle of the Single European Passport. This enabled banks with licence for financial operation in any country to provide cross-border services or open affiliates in any EU member countries. In these years the legislation of the European financial sector refines and makes the above principles more effective in order to further support the liberalization and the internationalisation of the markets. The liberalisation ultimately restructured the European financial systems, supporting cross-border services, promoting M&A activity within the European countries and the formation of financial conglomerates and syndicates.

Liberalization and internationalisation provided several challenges. The internationalisation naturally led to higher competition forcing the financial institutions to increase productivity and competitiveness. Whilst in the previous period increasing competition generally meant competition regarding service quality, in the context of internationalisation competition on financial markets means price competition of the same, high quality services. These courses brought to surface the relatively bad capacity utilization of the banking sector regarding labour, sales network and the accessibility of financial products. Increasing competition naturally complemented by the accelerated technological development, which finally led to the expansion of more competition-sensitive sales channels (e.g. internet banking) and was certainly affected by the introduction of the single European currency, also pointing towards a more standardised and globalised market.

Restructuring of the financial systems is at different stages in each Member States. These courses are expected to be amplified by the expected additional changes in the regulation of financial institutions, which will make the requirements regarding banks more similar in the level of operations, as well. In Hungary, the current regulation is more or less in line with the EU legislation. The greatest challenges will be posed by the rules, which are applied in the standardised European market and will take effect on the date of the EU accession. The general EU trends like internationalisation and increasing competitiveness will also put pressure on Hungarian financial institutions.

In the next few sections we will analyse the expected effects of the aforementionaed legislative issues, primarily focusing on the operations of the Hungarian banking sector.

Prudential Requirements

The prudential requirements of European banks are based on the 1998 Basel principles. The introduction of the Basel capital adequacy standards meant a significant step towards a single market, where all players in all Member States face the same conditions. The principles define the concept of regulatory capital, the risk weighting procedures of commercial bank assets, and the calculation of the capital adequacy ratio.

Introduction of the capital adequacy ratio was initiated by two main factors: first, there was a need to include off balance sheet items among the assets of financial institutions and second, to establish direct connection between reserve requirements of commercial banks and the risk they are taking in their portfolio. As a result, financial institutions with significantly different service and credit profiles became comparable from prudential point of view as the Basel capital adequacy ratio rapidly became widely-used throughout

Europe. As the Hungarian banking legislation is based on EU legal system, the current Hungarian prudential requirements are also based on the Basel principles.

Before introducing the risk-sensitive measurement of capital adequacy, banks could improve their figures only by providing additional capital (equity or sub-ordinated debt) or by cutting their credit portfolio. The Basel principles, however, allowed banks to restructure their credit portfolio in such periods, and to move towards lower risk assets, e.g. mortgage loans and government deposits, from the higher risk assets as consumption and SME loans.

The new regulation also eliminated the differences between the prudential requirements of institutions of the same type but under different supervision. However, it increased the differences between the banks and non-bank type financial institutions. As a reaction to this, several financial groups integrated their more risky activities into brokerage firms instead of banks in order to increase their capital adequacy ratio. In order to handle this problem, the standards had to be modified. Now, the risk taking of banks and other financial institutions is being handled much more at the same way.

In the recent years several imperfections of the Basel principles were identified, and finally the original concept was redesigned. The banking practice proved that the original Basel requirements failed to effectively manage the different types of risks. As the risk categories determined by the Basel principles are too broad, banks are forced to shift their credit portfolio within one risk category towards more risky assets in order to reach higher interest income on more risky assets. Under the current regulation, banks are able to act in the mentioned way without any effect on their capital adequacy ratio. As a reaction, the Basel Committee established new, refined standards for the prudential operation of Banks, known as Basel 2. The new requirements are expected to be introduced around 2006. For Hungary adoption of the new Basel 2 principles will provide the main challenge in the first few years after the accession.

The new Basel 2 principles are based on the following pillars:

1. Banks will be able to determine their capital need based on their own calculation methods for credit risk. The credit risk will be determined by the probability of the client's default, the expected extent of the loss, the exposure of default and the duration of the loan. The new credit risk evaluation will be much more sensitive to the real risk taken by a bank, thus the capital need of special borrowings will be much more precisely determined. Banks, lacking the above mentioned internal models will be able to apply the ratings of credit rating agencies.

   For prudential reasons, the new regulation will determine the capital requirement of securitised claims, which are taken off from the banks' balance sheet. As in Hungary the capital adequacy ratio of banks are far above the legally required 8%, securitisation is not present at the market. However, the next few years may bring substantial changes in this field.

   There are proposals to determine the prudential capital requirements linked to operational risks, as well. However, there are still debates on the issue and there is no clear idea of how the new rules would be included in the Basel principles.

2. The strengthened role of state financial supervisory authorities represents the next pillar of the Basel Principles. As banks will use their own methods to identify credit risk, the role of supervisory authorities must be increased in order to keep risk-evaluation under control. In the case of Hungary, the new situation will require higher competency from supervisory authorities, which is expected to bring substantial restructuring of their operation.

3. The third pillar of the Basel 2 Principles is the increased transparency of banks. This is necessary to enable market actors to get access to the information possessed by the banks and to monitor the activities of supervisory authorities more directly.

According to our expectations, the most important effect of the Basel 2 Principles will be the increased sensitivity of banks to the credit risk they take (Pillar 1.). This will eventually result in a clearer picture concerning the capital position of Hungarian banks and will lead to more precise information on the sector. The efficiency of risk management methods and the stability of the Hungarian banking system are to increase alike.

There is a broad debate on Basel 2 related to the stricter prudential requirements. The new standards will increase the volatility of the banking sector's capital adequacy ratio, which may result in more volatile movements in the aggregated credits of the Hungarian banking sector. As credit ratings are usually improving when the economy is in upswing and are generally deteriorating when the economy is facing a downturn, the lending activity of banks is expected to be higher in optimistic periods and lower in pessimistic times. This eventually leads to banks amplifying the economic cycle. For a country like Hungary, with an expected growth rate of twice of the European countries, such an amplification of the economic cycle could be even more dangerous than for an average EU country.

In addition, higher credit risk volatility may result in higher capital reserve need for banks in order to finance additional capital requirements, when the credit quality of their portfolio is worsening. This may lead to higher amount of capital required by the banks for their operations or much more volatile restructuring within the overall credit portfolio.

The new Basel principles will also bring changes concerning the evaluation of the sovereign debt rating. After introducing the new principles, the OECD member countries will be categorised by credit ratings and the risk weights will be determined not only by the fact of the OECD membership, but by the credit rating as well. As Hungary currently has below the OECD average rating, this will lead to a higher risk weight for the Hungarian debt than it was before, which will adversely affect the country's sources for new financing.

Rules on Provisioning

Although Basel 2 requirements are containing very special and well defined rules for the capital adequacy of the banking sector, the standardisation of provisioning rules is still an unsolved issue. Taking into account that rules for provisioning can influence the capital adequacy position of commercial banks very substantially, the lack of standardised rules endangers the primary goal of Basel 2, namely, to make the capital adequacy position of commercial banks more comparable.

In the EU the legislation distinguishes between provisions with general and special purpose. The general purpose provisions are used to cover problematic loans, which are are not yet identified. The use of these types of provision is strongly questionable from accounting point of view, as it provides possibilities for postponing tax payments. Special purpose provisions on the other hand are formed on well-identified problematic loans. General EU regulation requires special purpose provisions in each loan categories (non problematic, watch, to be managed, non performing) dependent on the days of delay of the actual debt service.

Concerning special purpose provisions, the Hungarian regulation proves to be flexible enough compared to the EU standards as it determines fixed bands for each debt category. Within these bands the bank is able to determine the level of the required provision in a flexible way. Two years ago the rules of general provisioning were also introduced in the Hungarian banking regulations. The new rules enabled the banks to include general provisions in their regulatory capital in order to open the door for this new type of provision formation. However, the Hungarian banks had not formed noticeable general provisions, so far.

Concerning the special provisioning practice of the Hungarian banking system it can be stated that the Hungarian banks are usually forming special purpose provisions only on the losses that have already been realised. Although the Hungarian regulation enables the Hungarian banks to form provisions on the expected, not yet realized losses related to their borrowing activity, the practice is different at the moment. With such an approach, however, it is clear that the Hungarian banks are forming relatively low level of provisions in the case of an economic upturn which is compensated by relatively high provision formation in economic downturns. Such a practice of Hungarian banks promotes the amplification of the economic cycles. The necessary changes regarding provision regulation in relation of the EU accession, however, are expected to be much less general and less influential than the changes regarding capital adequacy, simply because the EU regulation itself is still not standardised and homogenous in this field compared to prudential and capital-adequacy requirements.

Accounting Practice

The Directive on the Valuation Rules for the Annual and Consolidated Accounts of Certain Types of Companies as well as of Banks and Other Financial Institutions (Directive of the European Parliament and of the Council 2001/65/EC of 27 September 2001) accepted the IAS39 standards regarding the determination of the book value of bank assets on the basis of the fair value of the credit portfolio. This directive will come into effect in 2004, therefore it will require the amendment of the accounting principles employed by Hungarian banks, too. The integration of the fair value accounting principles into the Hungarian accounting standards is expected to provide several challenges for the Hungarian regulatory bodies.

According to the standards of fair value accounting, banks will have to incorporate non-realised losses in the book value of their assets. This clashes the current practice, when the book value is left unchanged in the case of asset devaluation and the bank is obliged to form provision. On the other hand, non-realised profits will revaluate the bank assets, as well, which is also different from the current conservative Hungarian accounting practice. The question is particularly important from the point of view of the banking sector. As the size of the bank assets will be more exposed to market movements it could make the adequacy to the capital requirements more difficult.

The integration of the fair value accounting principles into the rigid and conservative system of Hungarian accounting standards is likely to bring several questions and problems.

Regulation of Financial Groups and Conglomerates

In these days, one of the biggest challenges of the legislation of the European financial sector is the regulation of international financial groups and conglomerates. As a consequence of the accelerated financial innovation and the general trend of internationalisation within the EU, large multinational financial groups are expanding. Within a short period of time some of the sub-sectors (e.g. cross-border investment banking) of financial services could become dominated by such groups across Europe. The biggest problem with the regulation of international financial conglomerates is that in most cases members are located in different countries and subject to different local regulations. As a consequence, such groups often provide the possibility of regulatory arbitrage with transferring regulatory risks to countries with the most liberalised regulation on a particular issue.

During the past 10 years the EU issued several directives in order to create the basis of a consolidated banking supervision. Such directives were the Consolidated Supervision Directive (Council Directive

92/30/EEC of 6 April 1992), the Directive on Capital Adequacy of Investment Firms and Credit Institutions (Council Directive 93/6/EEC of 15 March 1993) and the Directive on Insurance Groups (Directive of the European Parliament and of the Council 98/78/EEC of 27 October 1998). The directives covered the holding-level rules and obligations on information, co-operation with the supervisory authorities and prudential operations. They also included the rules and limitations on the ownership structure, consolidated investments, consolidated risks and capital adequacy.

In spite of the above-mentioned efforts the European financial supervision is still fragmented and operating on a national basis. In addition, the supervision is often separated by financial sectors even within countries, giving different rules and guidelines for insurance companies, capital market institutions, pension funds and banks. It becomes more and more obvious that as the standardisation of the banking and capital markets' legislation successfully advanced during the past decade, the standardisation of the operations of local supervisory authorities allows for no delay. Moreover, by the Basel 2 Principles the role of the national supervisory authorities will become more important during the modernisation of the financial markets and in the creation of a more effective and more prudent common European banking system. For these purposes the European Committee established a discussion panel, called 'Joint Forum', in order to inspire the international conversation on this field.

In Hungary the EU accession is expected to bring further expansion of the international financial conglomerates. As a consequence, the regulatory bodies will face increasing pressure to respond to the challenge. Concerning the current state of the Hungarian legislation, the regulation of financial conglomerates is in an early stage. The main problem is that there are no holding-level, consolidated regulatory requirements to be followed by conglomerates, which own banks. Accordingly, in order to avoid regulatory obligations, plenty of financial groups operating in Hungary are by law not defined as financial conglomerates. As these kind of legislative deficiencies are not even conform with the EU rules, they are need to be resolved in a short period of time. As a general rule, in order to improve its regulation in the field of financial conglomerates, Hungary has to improve its relationship with the European financial supervisory authorities.

Questions of the Deposit Insurance System

The development of the Hungarian financial system is largely dependent on the trust in Hungarian banks and accordingly on the quality of the deposit insurance system. The experiences of Hungary in the 1990s (e.g. the Postabank case in 1998) and some other relevant experiences of the EU banking sector during the same period proved that the performance of the deposit insurance system largely contributes to the stability of the whole financial sector.

The guidelines of the banking deposit insurance system of the EU were created by the Directive on Deposit-Guarantee Schemes (Directive of the European Parliament and of the Council 94/19/EC of 30 May 1994), which determined the limit of banking deposit insurance in EUR 20 000. The directive also provided the possibility for banks to introduce retention and not give full insurance on deposits. However, a 90% minimum limitation was introduced on the level of insurance.

Currently, Hungarian banking deposits are insured for the maximum limit of HUF 1,000,000 (approximately EUR 4,000). To avoid the competitive disadvantage of the Hungarian banks to the local branches of foreign banks, the Hungarian legislative bodies already introduced higher maximum limit of the automatic insurance in the relevant Hungarian regulation. These changes will take place with the EU accession, and will lift the maximum limit to HUF 6,000,000 (approximately EUR 25,000) with 10% retention on the part of deposits above HUF 1,000,000. The retention on deposit insurance is a new tool in the Hungarian banking system, thus the reaction of clients is hard to predict.

The EU Internal Markets Regulation and the Hungarian Banking Sector

From the point of view of the banking sector, most of the questions regarding EU enlargement are related to the integration of Hungary's financial market structure into the Single European Market. As the country will adopt the Single European Passport principle, European banks will become able to provide cross-border services in Hungary either directly or through local branches without the prior approval of the Hungarian Financial Supervisory Authority (Pénzügyi Szervezetek Állami Felügyelete). Currently, concerning the dotation capital requirements, the Hungarian regulation handles the branches and affiliates of the foreign banks rather as banks than simple branches. Such distinction between branches of domestic and foreign banks will be eliminated with the EU accession. Hence, the expected effects of the Single European Passport principle in Hungary are very hard to predict and give reasons for several debates.

The first of the two main questions usually arise in this context is whether the Hungarian banks owned by foreign financial institutions will simply become local branches or affiliates of their parent companies. Concerning this question, there is no relevant foreign example. In the European countries foreign banks are generally controlling around 10% of the banking system. In contrast, around 75% of the Hungarian banking system is owned by foreign financial institutions. In our opinion, the transformation of Hungarian banks into affiliates is not a real threat. However, we can imagine centralisation in the treasury and risk management operations. As far as treasury activities are concerned, the centralisation could primarily influence foreign exchange desks. Considering the money market we see low potential for centralisation as the development of the market lags far behind the EU and has a lot of local characteristics. The general centralisation of the treasury activities could hapen only after the integration of the Hungarian money and capital market into the EU financial markets takes place. The process could be also accelerated by the EMU accession.

Concerning risk management activities, in general the decision-making processes of the foreign-owned Hungarian banks is already more or less concentrated into the foreign centre. As a general practice among foreign owned Hungarian banks, beyond a certain transaction size, risk management decisions are made by the central unit. Hence, the introduction of the Single European Passport Principle in not expected to bring dramatic changes in this field.

The second question is whether the introduction of the Single European Passport principle will increase the number of new branches owned by foreign banks. Considering the fierce competition in the Hungarian banking market, it seems to be unrealistic at the moment. The change could affect those banks for which retail network is not indispensable and which are closely depending on their parent companies. However, the market share of such banks is relatively low.

Overall, we expect foreign banks to enter the Hungarian market by acquisitions rather than by opening affiliates. On the other hand, those foreign financial institutions, which are currently not present in the market, are primarily expected to provide investment banking services in Hungary. They will be able to do this across the border, as such services are not requiring a retail network or branches.

Changes in the Mandatory Reserve Ratio

With the EU accession itself the Hungarian monetary policy will not need to adopt the standards of the mandatory reserve regulation. Hungary will have to reduce the employed mandatory reserve ratio to the 2% level of the Eurozone only by the accession to the EMU. Accordingly, the interest paid on the mandatory deposits of the commercial banks will have to be increased to the level of the central bank base rate.

Currently the mandatory reserve ratio is 6% in Hungary. The interest rate paid on mandatory reserves is 5.25%, which is below the current base rate of 6.50%. The reserve ratio was even higher in the middle of the 1990s, with a substantially higher difference between the interest rates paid on mandatory reserves and voluntary central bank deposits. The above factors are generally weakening the profitability of the banking system, so the convergence to the EMU is expected to improve the earnings of the banking system.

Besides the positive effects on the banking system, the convergence of the mandatory reserve policy to the EMU standard will improve global monetary conditions, too. The lower reserve rates imply broader money supply, which points towards decreasing interest rate level. Under favourable economic conditions it supports the expansion of the lending activities.

The Economic Effects of Hungary's EU Accession on the Banking Sector

In the chapter we will analyse the expected macroeconomic effects of Hungary's EU accession on the banking sector. The accession will influence growth, profitability, foreign investments, the labour market and the market structure both directly and indirectly. Among the direct effects the increasing competition and the expected consolidation of the market could have the highest importance. Among the indirect effects, top priority can be attributed to the interest rate convergence to the EU and expected better earnings, which will generally result from the increasing depth of financial intermediation.

The section will primarily focus on the direct effects of EU accession but will briefly consider the expected indirect effects, too. As we will see, the future of the banking sector from the point of view of growth, foreign investments and labour market is largely determined by the indirect effects. The accession will have direct effects mainly on foreign investments and the market structure.

Economic Growth

The broader financial sector generates 16.6% of the total national income. (The "broader" financial sector by the Hungarian statistical standards includes banks, investment service providers, other financial service providers, advisory firms and real estate intermediaries. We can assume, however, that the performance of the sector is basically determined by the activity of banks.) In he second half of the 1990s the share of the financial sector within the gross capital formation declined slightly. In 1995 financial intermediaries generated 17.2% of the total GDP, which gradually declined to 16.5% until 2000. After filtering out the distorting effects of the different price indices and other branches of the economy. Since then, however, an improving trend can be observed as the performance of financial intermediaries is exceeding the average performance of other national economy branches.

According to 2001 figures, the total GDP produced by the financial intermediary sector was 4.3% up on the previous year. This is substantially below the 7.8% growth registered in the year before. The slowdown resulted basically from the general downturn, economic growth was 3.8% in 2001 against 5.2% in 2000, which is reflected amplified in the performance of the banking sector. The other important factor having a role in the financial sector's slowdown was the general decrease of the interest rate level, which led to narrowing margins in the operations of the banking sector.

Regarding the 2002 figures, among the above mentioned factors the general economic downturn continued, having negative impact on the performance of the banking sector. On the other hand, the narrowing of the interest rate margins stopped, which overall helped the Hungarian banking sector to slightly improve its performance. The average growth rate of the GDP generated by the financial sector was up 4.1% y/y in the first three quarters of 2002, slightly up from the 3.8% y/y growth rate in the same period one year earlier. At the same time, in the first three quarters of 2002 the average growth rate of the financial sector was significantly above the average 3.2% y/y growth rate of the whole economy, which also indicates favourable change compared to the tendencies of the previous year, when the growth rate of the financial sector fell significantly below the average 4.1% growth rate of the whole economy.

The experienced 16.6% ROE of the Hungarian banking sector can be considered to be fairly impressive even in comparison to the EU. However, because of the relatively high Hungarian inflation, the real ROE was only 7.4%, substantially lower than the EU average. During the next few paragraphs we will briefly describe the expected performance of the financial sector from the perspective of the EU accession. For this we will use the operating profit level of the aggregated banking system as an indicator for the growth of the sector.

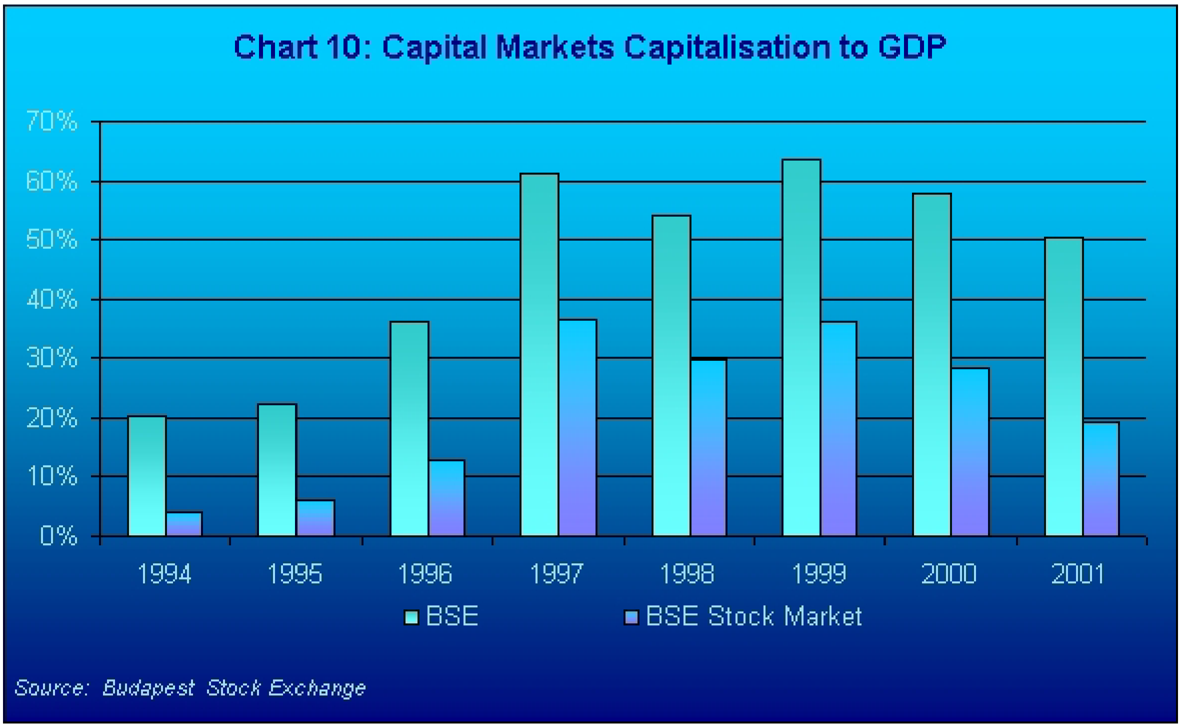
In recent years the deterioration of the profitability of the Hungarian banking system stopped. This resulted mainly from the shift on the asset side of the banking system, from government securities or central bank deposits bearing substantially lower interest rate, towards higher interest private sector loans. Other factors hindering the narrowing of interest rate margins were the slowdown of disinflation and accordingly, the stopping decrease of the general interest rate level. In 2001, the Hungarian Central Bank reduced the mandatory reserve ratio to 6% from the previous 7% and increased the interest rate paid after such reserves by 1 percentage point to 4.25%. The step was taken in accordance with legal harmonisation between Hungary and the EU, and also acted as a one-time positive effect on interest rate margins.

With the EU accession, the interest rate margins achieved by the Hungarian banking sector is likely to get impetus again. Some positive effects can be expected from the continuing shift in banking assets towards private sector loans and some impetus is expected from the continuing decrease of the mandatory reserve ratio and the increasing interest rate paid on it, too. However, these will not be able to counterbalance the expected negative effects of the fierce competition in the banking sector and the continuing fall in interest rates along with the fall of inflation.

In addition, as the loans to households and small and medium enterprises are generally more risky than typical corporate sector loans, higher ratio of such loans within the total bank assets could lead to increasing provisioning, which would negatively affect the banking sector's overall profitability.

Compared to the EU average, the ratio of non-interest type revenues within total revenues of the banking sector is substantially lower in Hungary. The structure of non-interest type revenues is basically in line with that of the EU, as the dominance of fees and commissions providing 61% of total non-interest type revenues can be observed. Based on the recent trends of the EU, we expect the fees on money transfers and related services to increase as banks will more and more build the costs of the IT development related to the advanced level of such services into the fees and commissions. The expansion of such revenues also seems to be assured by the fact that no substantial competition is expected to evolve in this field even after the EU accession. To sum up, convergence to the EU level is expected after the accession.

Considering the third typical business line of financial institutions, the revenues from investment and related services, in Hungary such incomes account for only 10% of total fee and commission revenues of the banking system being substantially lower than in the EU. In spite of the developing pension system, which is pointing towards the expansion of portfolio management activities, we do not expect significant change in this field as Hungarian capital markets are underdeveloped and the shortage of possibilities for investment service providers.



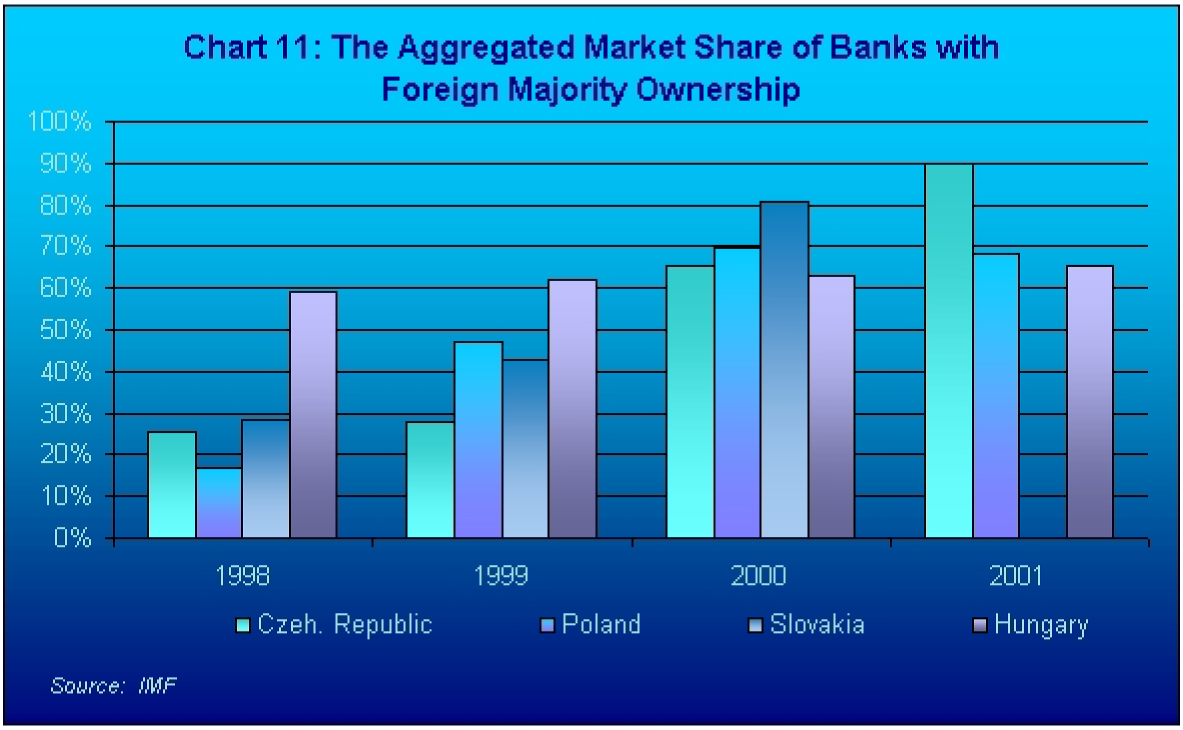
The operating costs of Hungarian banks, running around 3.7% of total assets, can be considered to be relatively low compared to the EU average. Within the operating costs, the ratio of labour costs is substantially below the average 55% of EU countries, which is attributable to the significantly lower unit labour cost (ULC). Although ULC is expected to increase in accordance with the convergence to the EU, we do not expect labour costs to grow as increasing competition will force the banks to increase their labour efficiency, too. The expected technological development of the Hungarian banking infrastructure will certainly allow the banking system to implement such measures. On the other hand, operating costs are expected to be raised by the necessary IT and other infrastructure development spending, pushing the depreciation of the banking system upwards, and counterbalancing the positive effects of the stable or lower lower spending on labour. Overall, we only expect a shift in the operating cost structure, whilst the ratio of operational costs to the portfolio size of the commercial banks is expected to remain unchanged on the medium term

To sum it up, on the operational level the decrease of interest rate type revenues is expected. The increase in fees and commissions may act as counterbalancing factors, moreover, in the longer run, with the revival of the Hungarian capital markets, fees related to investment banking services could also increase. As operating costs are expected to remain stable, overall we expect the slight deterioration of the Hungarian banking sector’s profitability after the EU accession. However, the deterioration will result from general macroeconomic trends (e.g. falling interest rates), EU-related changes within the sector (e.g. expected increase in competition) will only have smaller effect on the Hungarian banking sector.

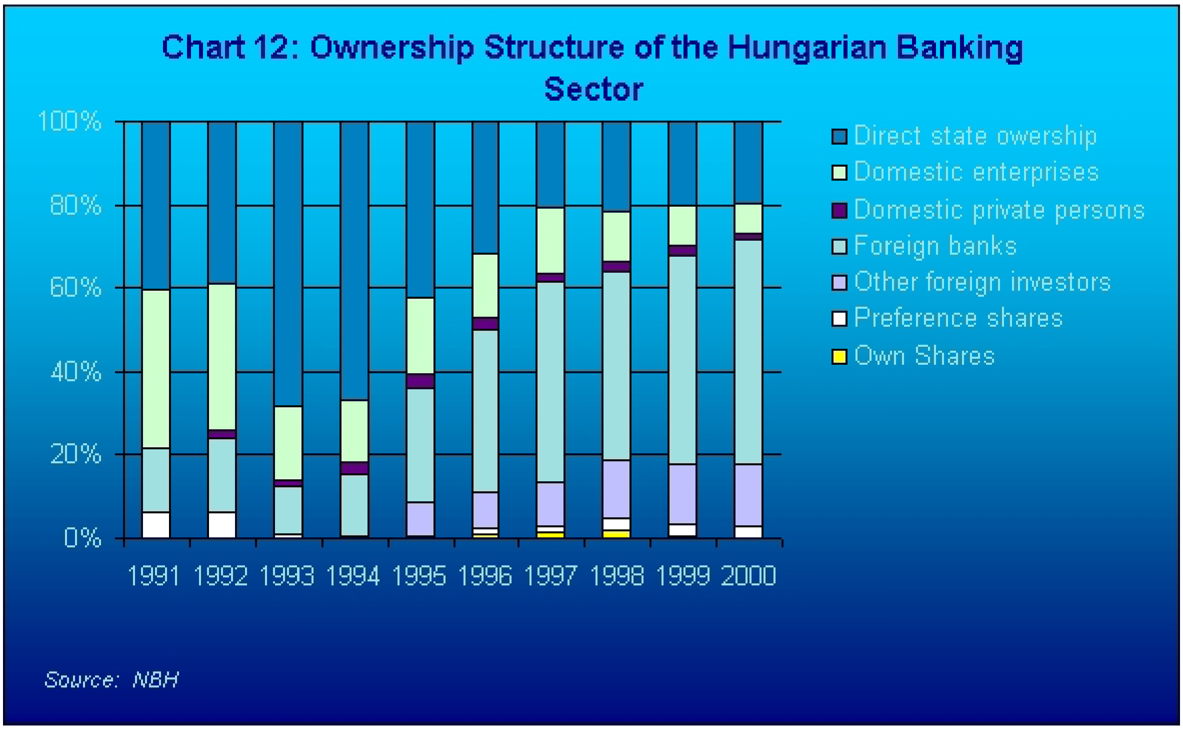
Thus, in the longer run the increase of the depth of the financial intermediation and not the improving profitability of the banking system is expected to be the main driving factor for the growth of the Hungarian financial intermediaries.

Foreign Direct Investments

Within the approximately EUR 24 bn total foreign direct investments in Hungary cumulated after 1990, approximately EUR 2-2.2 bn was invested in the Hungarian banking sector. The lions share of these investments was made between 1991 and 1997 and was linked to bank privatisation. Several green field banking investments could also be observed in this period. The majority of strategic investors in the Hungarian banking system were large European financial institutions.



Before the consolidation of the banking system, the total share of foreign investors was stable around 10-12%. After the privatisation process the share of foreign strategic investors quickly increased to 70-75% with the dominance of strategic investors. Thus we can say that the Hungarian banking system is dominated by foreign capital. The EU accession itself is not expected to bring substantial changes in this field. It only increases the probability of market restructuring by consolidation and the expected boost in the mergers and acquisitions activity.



However, substantial changes can be expected by the new privatisation wave unfolding in these days in Hungary. The privatisation of Postabank, the Land Credit and Mortgage Bank and Konzumbank provides the last opportunity for foreign players already present in Hungary to increase their market share and to reach the critical mass of loan portfolio before the consolidation of the Hungarian financial services market begins with EU accession. From both points of view, we expect that the foreign strategic investors will actively take part in the last phase of the Hungarian bank privatisation.

In the case of Postabank, which is one of the largest Hungarian retail banks, we expect the majority of the bank to be taken by a foreign strategic investor. As the Hungarian retail market bears a large potential, we can imagine a new financial institution to enter the Hungarian market by acquiring Postabank. However, as the Hungarian retail banking is dominated by the former savings bank of the monobank system, the acquisition of Postabank could primarily be interesting for those banks which are already present in Hungary. The drive behind is the growth of market share in retail banking, which offers substantially higher interest rate margins than the corporate banking sector.

The Land Credit and Mortgage Bank, having a unique position in mortgage lending in Hungary, also represents an attractive target for foreign financial institutions. By acquiring the bank, a foreign strategic investor could enter the Hungarian market and at the same time get hold of a solid position in mortgage lending. In order to ensure the continuity of the current form of the Hungarian mortgage lending system, based on the co-operation of a central mortgage bank and the commercial banks acting as its selling affiliates, the State may intend to sell the bank to a foreign investor who is not present in the market.

According to our expectations, Konzumbank will be an interesting acquisition target primarily for an investor who is already acting on the Hungarian market and intends to expand its retail banking operations. Again, concerning Konzumbank, substantial interest is expected from the foreign investor side.

According to our estimations, the above mentioned transactions could have a total value of around EUR 1.5-2.0 bn. Assuming that the majority of these institutions will be acquired by foreign investors, the transactions are expected to lift their total ownership ratio in the Hungarian banking system well above 80%. Afterwards, further increase in the foreign stake cannot be expected. Thus FDI to the Hungarian banking sector will be in line with its general growth pace. Beyond the transactions described above, the EU accession itself will not have significant effect on the foreign direct investments in the banking sector.

As it was shown is section 0, the structural characteristics of the Hungarian banking sector suggest that the number of banks in Hungary is relatively high compared to the depth of the financial intermediation. As a consequence new entrants in the Hungarian market can be expected only with the increase of the depth of the financial intermediation, which is likely to happen in relation with the convergence to the EU. This ultimately will result in further direct investments in the banking sector from the EU countries.

Labour Market

On the level of the national economy, the expected effects of the EU accession on the labour markets are important from the point of view of the labour competitiveness and from the point of view of the Hungarian standard of living, too. In the level of the banking sector the effects of the labour market tendencies on the profitability and general growth prospects of the sector are also to be analysed.

In the banking sector, competitiveness is of less importance than in other traditional economic branches. The reason behind is the very low foreign trade activity in the financial intermediary sector. The net exports and imports of financial services are basically restrained to the exports and import of money management, money transfer and related services and the cross-border banking activities, such as investment banking services. However, as these kind of activities can be characterised by low labour intensity, the sector can not be considered to be really exposed to foreign labour competition.

In Hungary, the labour costs are lagging fair behind the EU level. The average wage level is approximately 30% of the EU average on the basis of purchasing power parity and 11% on the basis of nominal exchange rates. The numbers are below the Hungarian GDP per capita level to the EU level either, which is 50% on purchasing power parity basis and 21% on nominal exchange rate basis. Although there are significant differences in terms of labour costs among the accessing countries, Hungary still belongs to those with the lowest wage level. The above mentioned facts suggest that the EU accession will bring increase in the Hungarian wage level in the course of the expected convergence. The overall increase in the wage level, however, is expected to have only limited effects on the Hungarian banking sector, since the average wage level of the Hungarian banking sector is around 200% of the whole economy’s average.

In the short or medium term, we expect the Hungarian banking system to increase its labour efficiency in order to reduce the labour related expenses within the operating costs. The main driving force of such courses will be the introduction of the more effective IT infrastructure in the banking sector, which is expected to allow financial institutions to increase their size regarding assets and liabilities without increasing the number of employees. Based on the experiences of EU countries in the last few years, such changes will affect mainly the retail branches, which are expected to move towards the European model of retail banking with very low number of employees.

On the medium run, however, as the depth of the financial intermediation increases and bank deposit and credit portfolio grows, the financial sector’s demand for labour may also increase. However, this could only come after that the expected consolidation of the banking system took place and the general macroeconomic conditions moved the banking system towards increasing the depth of financial intermediation.

Expected Changes in the Structure of the Banking Sector

Taking into consideration the general trends of internationalisation and consolidation of the banking sector in EU countries, it can be stated that a substantial shift is observable in financial intermediation from the bank based market segmentation towards the market based one. This was the natural result of the movement of banking systems operating in fragmented local markets towards large multinational conglomerates.

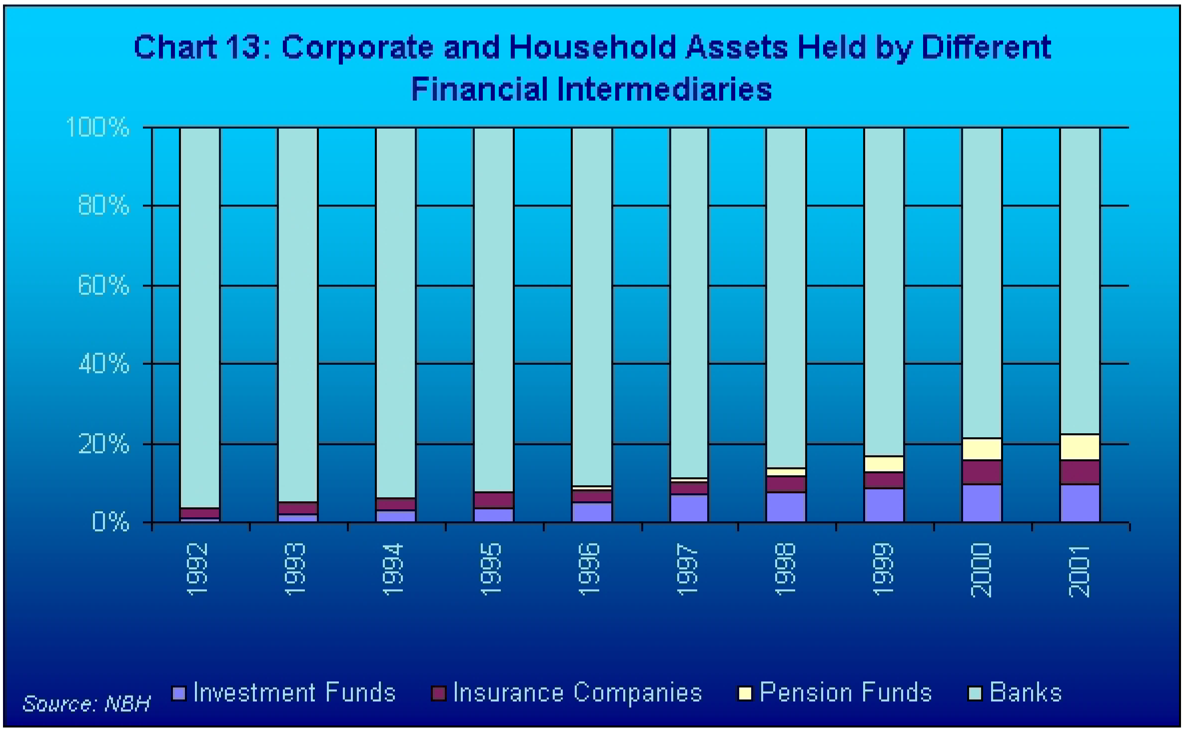
With Hungary's accession to the EU we anticipate the acceleration of the consolidation process. In the last few years several signs of consolidation already showed off in the country's market, moreover, strategic transactions were carried out that influenced the whole market and pointed to the same direction. We believe that the EU accession will give further impetus to the concentration of the market, and will support the intensification of competition. In our opinion there are three main reasons why the consolidation of the Hungarian banking system will accelerate.

First, technological development increased the minimal size of a bank, under which it can be operated effectively. Expensive IT systems require higher credit portfolio and larger client base, moreover, electronic banking and payment methods can be implemented economically only if a large number of customers uses the systems.

Second, with fiercer competition, there is an increasing need to improve cost-efficiency regarding labour and other operating costs. As the disintermediation gains ground, there will be substantial cost-efficiency pressure imposed on banks. Larger organisations are definitely able to handle such problems more effectively.

Third, the EU accession will complete the deregulation in the field of cross-border banking and financial services. Larger institutions have better position from the point of view of stronger competition expected to be brought by deregulation. On the other hand, large corporations will be more able to provide cross-border services in other European countries and thus will be able to benefit from the Single European Passport principle.

The consolidation of the banking sector obviously leads to higher amount of deposits and higher amount of loans controlled by one institution. The concentration of the assets and liabilities of the banking system points towards the disintermediation as more and more assets and liabilities reach the critical size from the capital market point of view. Above a certain volume of deposits and loans, the institutional investors or the capital market itself can more efficiently serve as financial intermediaries than the banks. In Hungary, the early signs of the expansion of capital market financial intermediaries are already observable. For example, with the reform of the pension system increasing amount of the household savings is managed by institutional investors. As a result, nowadays 22% of the total household assets is managed by the institutional investors, which indicates a substantial increase compared to 9% in 1996. From this point of view, the portfolio management companies (like investment fund managers and asset managers) are expected to take over the management of household savings against the traditional banking sector.



It is very difficult to predict how the consolidation will take place in the Hungarian banking sector from the point of view of the number of institutions. In accordance with international trends, the number of banks is expected to fall in the short term. In this field, changes are likely only in the depth of the financial intermediation. In the 15 EU countries, the number of banks increased only in Luxembourg, Greece and Ireland during the 1990s. In the other Member States the number of banks fell dramatically. For instance, Sweden faced 75% decrease, whilst 50% was experienced in France and Spain alike.

In most of the European countries, the five largest banks are dominating the banking sector. The highest concentration can be observed in the Netherlands, Denmark, Belgium and Sweden, where 80-85% of the market is controlled by the top5. The market concentration is the lowest in Germany, where the five largest banks control only 19% of the market. In Hungary the top five banks are controlling 60-65% of the market, which is around the EU average. However, a significant difference can be observed regarding the corporate and retail banking, as the concentration of the corporate banking subsector is about the half of the concentration of the retail sector. Thus after the EU accession a strong competition is expected primarily in the corporate business. Concerning the retail business, for the local savings bank, which dominates the Hungarian market, keeping the market leader position will become more and more difficult. The concentration of the market is expected to bring new, well capitalized entrants and is expected to conclude in intra-market mergers or acquisitions, too.

The above mentioned courses suggest that the Hungarian banking system will remain under the control of foreign financial institutions even in long term in spite of the fact that in the EU countries, the role of foreign banks within the banking system is generally limited.

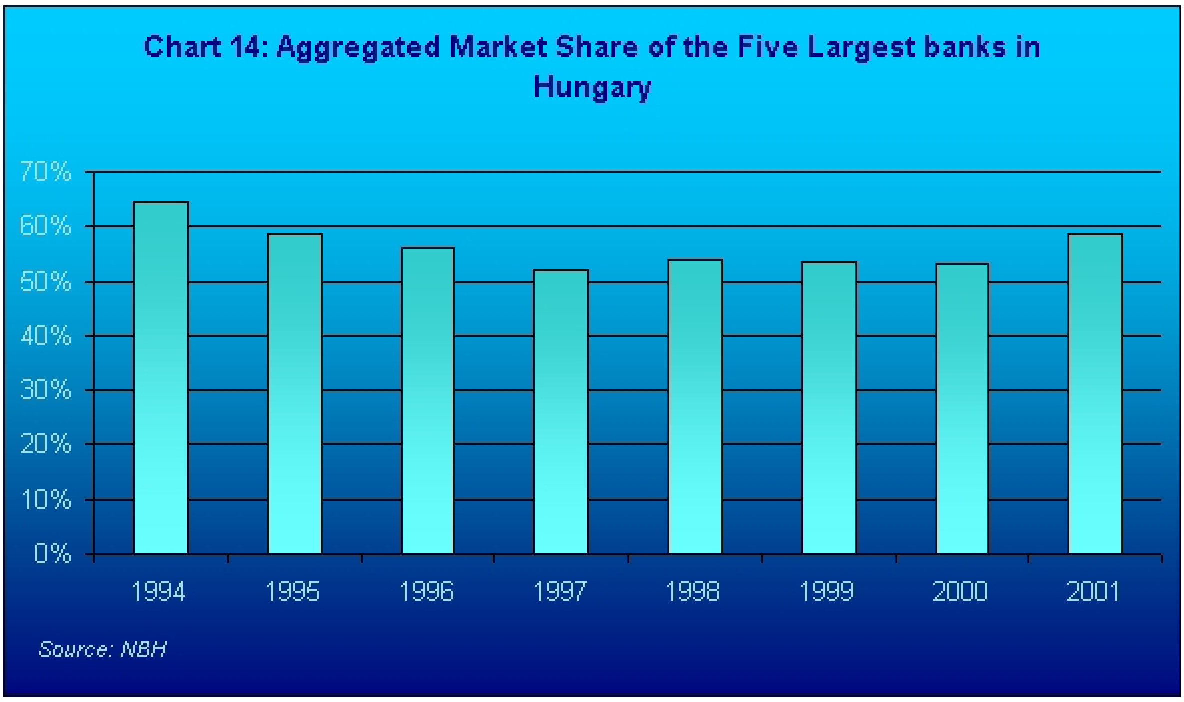


Chart 14: Aggregated Market Share of the Five Largest banks in Hungary
70%
60%
50%
40%
30%
20%
10%
0%
1994
1995
1996
1997
1998
1999
2000
2001
Source: NBH

Conclusion

The Hungarian banking sector belongs to those market segments which are in a favourable position with regard to the EU accession. The eligible level of the sector's development was supported by the fact that several multinational banks entered the market already in the mid 1990s. This accelerated the process of deregulation and liberalisation of the markets and allowed the financial sector to play a major role in the economic development. At the same time it helped Hungary to open its market to international competition and to prepare for the EU accession well in time. From the point of view of liberalisation and deregulation of the market of financial services, we can assume that Hungary is more or less part of the European Union. This ensures that the accession itself will not bring shock-like effects to the market.

Those courses which are evolving in the banking system of the EU these days, such as disintermediation and the strengthening role of institutional investors in financial intermediation, will not necessarily characterise the Hungarian banking system even after the accession. The explanation could be the significant difference between the structure of the banking systems and the relatively underdeveloped capital markets.

Financial institutions, which are already present in the Hungarian market will have to prepare for the challenges of maintaining their profitability in a consolidating and concentrating banking sector after the enlargement. For such institutions the solution may be the implementation of additional know-how and advanced business models in retail and SME banking. The necessity to make greater use of information technologies in order to improve the quality of banking services and to explore new areas of distributing banking products could also provide substantial challenges.

The Hungarian government and the Hungarian regulation are in a relatively favourable position, as most of the reforms required by legal harmonisation have already been implemented. However, the privatisation of the remaining state-controlled financial institutions will require active management from the government and the legislation even in the last phases of the accession.

For Hungary the most important and most direct effect of the EU enlargement will be the consolidation of the banking sector through mergers and acquisitions and the increased competition, which will put substantial pressure on profitability and will force the banks to cut costs and improve their efficiency. This in the short term will result in the decrease of the number of banks operating in Hungary. However, in the longer run, by the convergence of the depth of financial intermediation to the EU practice, growth prospects for the sector will improve.

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