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COUNCIL CONTRACT NUMBER: 807-07

DATE: August 11, 1993

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* The work leading to this report was supported by contract funds provided by the National Council for Soviet and East European Research. The analysis and interpretations contained in the report are those of the author.
BANK RECAPITALIZATION:

HUNGARY'S SECOND ATTEMPT AT RESOLVING ITS CREDIT MARKET CRISIS

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Contract #807-07

Abstract

The large public Hungarian commercial banks are, as a group, insolvent by international standards. In an attempt to resolve the problem, the government implemented a loan consolidation scheme with multiple objectives, namely, recapitalize the banks, consolidate and work out the loans of troubled companies, and facilitate the restructuring of loss-making companies. The program failed because its design was flawed. Hence, the Hungarian government is considering a second scheme based on recapitalization to resolve the financial crisis of the banks. For any program of financial sector reform, we argue that the three objectives pursued in the first Hungarian scheme should be separated and that recapitalization is the appropriate focus for the first step. Programs for the consolidation and work out of bad loans and for enterprise restructuring should be financed transparently in the fiscal budget where the tradeoffs can be analyzed carefully.
The Hungarian government's loan consolidation program of 1992 (LCP) failed to recapitalize the major state-owned commercial banks and did not put in place a mechanism for using the banks' information on their clients to work out the bad loans removed. The core of the problem is the financial situation of three large public commercial banks, in descending order of asset size, Hungarian Credit Bank (HCB), Commercial and Credit Bank (CCB), and Budapest Bank (BB). The addition of a fourth public bank which is financially sounder, the Foreign Trade Bank (FTB), captures the bulk of the commercial banking sector in Hungary. The largest Hungarian bank, the National Savings Bank (NSB), accounts for about forty percent of all bank deposits and is also on shaky financial grounds. The government is currently considering a second program to improve the financial health of the banks. The urgency of doing so is underscored by recent disintermediation.

Although the final details are still to be decided, the Ministry of Finance (MoF) announced that two aspects of the 1992 LCP will be altered. First, the stabilization tax which allowed the MoF to recapture up to fifty percent of the interest payments made to the banks on the loan consolidation bonds (LCBs) is to be rescinded. Second, LCBs will no longer be divided into two series, A and B. The LCP treated capitalized interest arrears differently from loan principal in that series A bonds were issued to replace loan principal whereas series B bonds were issued for interest arrears. Series B bonds paid only fifty percent of the series A interest which is equal to the average yield on 90-day Treasury Bills. The potential for levying the stabilization tax and the fact that series B bonds earned less than a market interest rate led to an estimated write down of the face value of LCBs from HUF

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1 For an analysis of this program, see Ábel and Bonin, "From Bad Loans To Tainted Bonds: The Credit Market Crisis In Hungary", August 1993.
Hence, a policy that rescinds the stabilization tax and converts series B bonds into their series A counterparts is an important first step in recapitalizing the Hungarian commercial banks.

The second program also recognizes the need to separate the three objectives of financial reform, namely, recapitalizing banks, consolidating loans to facilitate work out, and restructuring large loss-making state-owned companies. Three separate procedures should be designed, one to deal with each problem. The urgency of the first objective makes it the focus of the 1993 Hungarian scheme. Loan consolidation and the design of a work out scheme can be implemented only after thoughtful planning and consideration of the alternatives. The restructuring of loss-making state-owned companies should become part of industrial policy not financial reform.

The problem of bad loans is, to a large extent, a confusion of financial policy and industrial restructuring. As direct fiscal subsidies to companies were eliminated, the banking system was left to support ailing state enterprises. Hence, subsidies continued but in the form of transfers from companies meeting their loan obligations at high interest rates to companies that were not servicing their debt. These nontransparent financial subsidies are the major cause of credit market gridlock.

Complete details of the 1993 Hungarian scheme have not been announced but full recapitalization of the banks should adhere to four principles. First, the establishment of proper governance to preclude a recurrence of the bad loan situation is crucial. If a program

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2 See Ábel and Bonin, *ibid.*
does not reward prudent management when it has already occurred, it sends an inappropriate signal to managers. To this end, using public funds to bring each of the four large commercial banks up to a target capital adequacy ratio (CAR) based on IAS is inappropriate. These four commercial banks emerged from the LCP in quite different financial shape. Using IAS, World Bank forecasts of CARs for 1993 after LCP are 16.1% for FTB and 2.2% for BB. On the other hand, HCB and CCB have negative forecasted CARs of -7.9% and -8.5% respectively. Intense provisioning in 1991 and 1992 and a carefully crafted strategy for the LCP allowed BB to improve its CAR substantially. Hence, any policy that levels the playing field ex post with public funds would discourage the type of prudent management exercised recently by BB and exacerbate already existing moral hazard problems.

Second, using IAS standards to adjust bank assets to calculate CARs is problematic to some extent. Now that the stabilization tax is rescinded, the major difference in Hungarian Accounting Procedures (HAP) and IAS measures of the CAR is the treatment of deferred provisions. The Hungarian banking act instituted deferred provisioning to phase in the required accumulation of loan-loss reserves. In our opinion, this was appropriate to avoid an even greater financial shock as a short-term flow solution to an outstanding long-term stock

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4 Because the stabilization tax was a potential deferred liability for the banks, the value of the CBs was written down to reflect the maximum payment, one-half of the interest paid on CBs. It is important to note that, even if they had sold the CBs, the banks would have been liable for the stabilization tax. Since the tax could have been levied at rates below the 50%, the actual value of the CBs to the bank may have been greater than the NPV calculations using the maximum liability. Hence, these forecasted CARs could be considered to be low estimates.
problem was sought. However, CARs calculated using IAS do not recognize this adjustment period. If some combination of government recapitalization and gradual bank-funded accumulation of loan-loss reserves is desirable, a phase-in period is defensible.

Third, the effect of the deep and continuing recession on CARs should be recognized. Financial distress is not unique to the post-socialist countries in transition and below-average bank CARs accompany recessions all over the world. To design a recapitalization scheme based on CARs calculated in deep recessions may overestimate the support needed. On the other hand, the HAP is often criticized for being backward-looking, i.e., it recognizes problem loans after the fact, whereas prudent portfolio management dictates a forward-looking estimate that anticipates forthcoming problems. To what extent the bankruptcy legislation has enforced a forward-looking solution by its somewhat draconian conditions is difficult to tell. Anecdotal evidence indicates that some bad debt in banks’ portfolios is not yet classified as such because the bank is "protecting" its client from bankruptcy. With no data on the extent of this behavior, it is impossible to know whether a forward-looking approach would add substantially to the qualified part of banks’ portfolios.

Fourth, and related to the first principle, the issue of using public money to bail out present management and shareholders must be addressed. The equity claims of existing shareholders who do not participate in raising new equity should be subordinated in some

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5 See Abel and Bonin, op. cit.

6 To the extent that the existing shareholders are public institutions, the issue may look like an accounting exercise. However, the incidence of recapitalization may not be purely distributional; rather the cost born by certain groups (e.g., municipalities or pension funds) may affect their activity if they are not also recapitalized.
way to those who provide the new equity. Furthermore, a sliding-scale should be designed so that the banks with CARs (using IAS) be increased toward this target but that existing differences in CARs among the banks not be equalized but only reduced. Of course, any recapitalization scheme that uses public money must consider the fiscal implications (budget constraint) of the plan and should not lead to undue government interference in bank governance.

Recapitalization of the banks is often linked with removing the bad loans from the banks’ balance sheets and making arrangements for their work out. Loan consolidation and work out has a dual purpose, to identify and package efficiently the bad debt and to manage the resulting portfolio to maximize the present discount value of the eventual return. The basic principle for efficient work out is to match expertise in managing the portfolio with the necessary financial information.

A market-based approach involves transferring the rights to work out the bad debt to the purchasing agent. The presumption is that the bad debt will then be in the hands of the agent who is most adept at work out. Unfortunately, the efficiency property of auctions depends on the information available to the potential bidders. In Hungary, a secondary market for bad debt is likely to be extremely thin. The agents with the best financial information on the debtors are the commercial banks themselves. These few large public institutions are not sufficient to generate competitive bidding. Hence, the market-based option may not exhibit the desired efficiency properties because of impacted information.\(^7\)

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\(^7\) Even in U.S. financial markets, the auction of bad debt from the bankrupt savings and loans was initially very difficult. When the government provided some financial assistance, the bad debt sold quickly but only at deep discounts.
The centralized approach involves removing the bad debt from the balance sheets of the commercial banks and placing it in a "sink" bank. Efficient work out then requires that the sink bank find a mechanism to extract the information commercial banks have on their clients.8

An intermediate strategy can be designed; one that both uses the information where it resides and encourages the participation of agents with the necessary expertise. The government should consolidate the loans of any individual debtor into a single package and, if necessary, group together the loans of several companies to make the resulting package more attractive in size and diversity. The package should be placed with a lead bank, presumably the commercial bank with the most information on the loans involved. An incentive contract should be designed to induce the bank to seek the maximal eventual value (in discounted terms) of the package. The contract should encourage the involvement of a partner with particular expertise in loan work out (e.g., a foreign financial company). Although state-directed, this proposal uses the information that resides in the commercial banks to work out the loan. Given that loan work out takes time, having the informed commercial bank involved as a monitor of managerial activity during the work out period should reduce asset erosion. Thus, state-directed, commercial-bank-based work out is likely to result in higher recovered values of bad debt.

Enterprise restructuring cannot be separated entirely from bad debt work out. The banks will have a major informational role to play in restructuring but the crucial principle to

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8 In Czechoslovakia, this procedure was followed for a particular type of bad loans when the Consolidation Bank was established as a sink bank. Progress to date has not been encouraging.
follow is transparency. Government support of certain companies and sectors, when appropriate, should be done transparently and financed by the fiscal budget. If employment maintenance argues for a gradual restructuring of companies (in particular in certain regions of the country, perhaps because of the relative immobility of the regional labor force), sunset procedures should be adopted and funded directly by the fiscal budget. In short, industrial policy must be recognized explicitly as an interim part of the safety net in the transition, and the financial implications of pursuing clearly outlined government objectives must be borne by the fiscal budget and not the banks.

The 1992 LCP failed because it tried to satisfy multiple objectives that should be separated for policy purposes. Of course, bank recapitalization, consolidation and work out of problem loans, and enterprise restructuring are related and have interdependent elements. Nonetheless, separating them conceptually is likely to lead to better-designed polices in which goals can be both articulated and prioritized. Then the tradeoffs will be transparent and the policy decisions taken subject to the fiscal budget constraint will be based on rational criteria. The 1993 Hungarian scheme, if designed properly, could be the first step in a successful second attempt to resolve the credit market crisis.