

# **“ Financial Transition in ECA: Challenges of the New Decade”**

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## *Banking and Capital Markets in Hungary: Achievements and Prospective Challenges* **DRAFT**

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István Szalkai:

Banking and Capital Markets in Hungary: Achievements and Prospective Challenges

***1. Summary: what lessons can be learned from the Hungarian experience and what are the major challenges for the next decade?***

The transformation of the Hungarian banking and capital markets started with the establishment of a regulatory framework, which even in its initial form had wished to conform to international standards. As a result, a rapid restructuring was achieved in the financial sector, especially in the banking system in the first half of the 1990s. Consecutive changes in financial legislation has resulted in good compliance in Hungary, both with the directives of the European Union and Basle Core Principles. Supervisory structures have followed market developments with a partial integration in 1997 and a full integration of banking, securities, insurance and pension fund supervisions from April 1, 2000.

Based on sound regulatory requirements, a significant progress has been achieved in other infrastructure areas of the financial system, including payment and settlement systems, business technology and training.

In Hungary it was realized that a gradualist or “growing out” approach to structural problems (including bad loans) of the banking system is not compatible with the fast privatization of banks. Strategic investors wanted to see reasonably clean balance sheets and officials responsible for privatization were aware that hidden portfolio problems could create confidence problems later, and eventually make further sales less beneficial and undermine the development of banking and capital markets. Portfolio cleansing of banks and their re-capitalisation was regarded as a precondition of successful privatization, and this was carried out in two stages in the 1993-95 bank rehabilitation program. Although troubled banks were requested to prepare recovery plans in order to obtain government financial support, the management consequences of bank problems were not clearly and exactly defined and therefore not sufficiently deterrent.

As a result of the factors set out above, there was a very rapid increase in foreign investors’ participation in Hungary, especially after 1994. In the reestablishment of confidence of foreign investors, 1995’s successful stabilization program (also known as the “Bokros program”) played a crucial role. By the end of 1999, about two-thirds of the registered capital of credit institutions were in the hands of mostly foreign strategic investors and foreign participation in the equity section of the stock exchange was more than 70 percent. The presence of foreign investors contributed to a further improvement in management and technology as well as in corporate governance, internal and external audit. At the outset, restructured banks remain risk averse and concentrate their traditional lending activities mainly to blue chip customers. Recently fierce competition drove them toward middle markets. Innovative fee-based business has a growing importance and human factor rapidly appreciates in this process.

Where owners’ control on bank activities continue to be weak, corporate governance and external audit have become insufficient. The supervision authority remains inefficient in conducting supervision on a consolidated basis, and bank losses could remain hidden in the banking groups or

connected activities for years. The case of Postabank (1998) illustrates that a mismanaged privatized bank without appropriate control can accrue such losses, raise the threat of systemic consequences and finally force the Government to adopt a very costly rescue action.

Banking sector depth increased moderately following the 1995-stabilization program. During the same time there was a remarkable increase in the intermediation by institutional investors, e.g. mutual funds, pension funds and insurance companies. The introduction of a three-pillar pension reform system) in the second half of the 1990s – which itself relied on capital market progress achieved at that time – was instrumental in accomplishing this. All these contributed to an increase in capitalization, volume traded, depth and liquidity of capital market. Both the banking sector and institutional investors are highly concentrated. A significant part of their activities were carried out by financial groups controlled by foreign strategic investors. Beside banking, larger groups typically offer investment services and fund management through separate subsidiaries. Since the beginning of 1999, financial institutions obtain authorization to offer banking and investment services under the same roof.

The institutional maturity of the Hungarian financial markets was proven when adverse external shocks came. The confidence in the stability of a network and operations of financial intermediaries has always been preserved and institutions remained quite resilient. But it is worth noting that the first line of defense was provided by the sound, stability oriented policies of the Hungarian Government.

Major challenges for the next decade are summarized below:

- Hungary's membership to the European Union and further integration with the international financial systems require full harmonization of the Hungarian financial regulations with that of the European Union, as well as full compliance with the Basle Core Principles during the next 3-5 years. There are five major issues to be treated in this field: (a) capturing and measuring market risk; (b) enhancement of consolidated supervision; (c) an increase in the regulatory powers of Financial Supervision; (d) improved possibilities for timely corrective supervisory measures; and (e) the achievement of an increased international supervisory co-operation in order to implement consolidated supervision including cross border transactions.
- Integration of the Hungarian financial system with the European and global financial system requires the removal of remaining structural problems of financial institutions. With a further increase in competition in the financial markets, these structural problems can prove to be irrecoverable competitive disadvantages. One of the major issues in this field is high operational risk in some institutions where the IT development was not well devised and management information systems suffer from weaknesses.
- The market concentration is expected to increase further. By the middle of the next decade, 6-8 financial institutions providing universal banking services will control the majority of the Hungarian financial markets. These groups will be the market leaders in offering specialized banking services (real estate, home and car finance) as well as non-banking financial services (leasing, factoring). Some of the smaller banks will be transformed into branches of foreign banks if the regulation is eased. However, foreign non-deposit taking institutions in consumer finance will increasingly penetrate but they fund themselves basically from abroad. Only a few small banks can survive on niche playing. With increasing familiarity and access to electronic banking from major international institutions, the viability of savings cooperatives over the next ten year period

is questionable even with improved capital strength and institutional framework. In the second half of the next decade the concentration process will continue, but due to the overwhelming foreign ownership, mergers and acquisitions in a wider European framework will determine the outcome. Among the reasons for mergers will be basically the commercial banks' efforts to improve cost savings under competitive pressures. The geographical and functional diversification of their activities, and efforts to achieve the appropriate size in order to increase profitable activities and competitive edge in a larger, unified market.

- Banks have already made substantial investments in the development of internet banking in Hungary, which they typically own. Internet banking is suitable to supplement a branch network and, in prospective, even to replace it. It will also be a typical way in the future to offer financial and investment services abroad, and therefore it can be an alternative for cross border mergers. It appears that besides households, there is a remarkable increase in demand for on-line services in small and medium-size businesses where the cost and time saving nature of these facilities is promptly recognized. The challenge for supervisors in this field is that several elements of this progress are out of supervisory oversight. Supervisors have to study and understand the process, estimate the speed and scope of expansion, respond with appropriate explanation to customers as well as regulations to mitigate emerging risks.
- By joining the Euroland and using the TARGET, the importance of the correspondence banking and the documentary business will be reduced since an overwhelming part of banking transactions are conducted with these countries. It is apparent that banks already compose their budgets with a consideration for this development.
- The low average level, high variance in profitability and the large number of loss makers means a challenge for the next 3-4 years for the Hungarian banking system. It is expected that where capital replenishment is required, owners will provide for this in the near future without major difficulty. In light of further pressures on profit margins due to increased competition and the difficulty in increasing fee-based businesses and to improve cost efficiency beside structural deficiencies, it may take a longer period for several banks to achieve a break-even status. Although the probability of the emergence of problems with systemic consequences is fairly low, the owners' behavior in the latter cases is less predictable and might raise supervisory concerns at a later stage.
- As a result of freeing up the entry of foreign investment funds' products into the Hungarian market, and the further strengthening of the fully funded pillars of the pension system, as well as the growing share of bank assurance activities in financial groups, there will be a continued rapid increase in intermediation through institutional investors. Institutional investors will contribute further to the development of capital markets both in terms of depth and liquidity and reducing risks by increasing demand for improved disclosure, risk rating as well as corporate governance. Changes in the structure of the intermediation may cause problems for certain credit institutions. The majority of the market, however, will be controlled by financial groups which, through their diversified activities, can manage these changes without difficulties.
- In areas of inadequate finance one of the major challenges for the next 5-10 years is the development of a secondary mortgage market. This will provide liquidity to primary market

lenders and improve market efficiency by moving toward a standardization in mortgage lending. It is already apparent that during this process there will be a movement from the German to the American model of mortgage finance (the core of the secondary market will be one or more government supported institutions). Another challenge in this process is the long term viability of home savings banks which need to be maintained and that home savings (Bauspar) and mortgage finance have to stay complementary. The improvement of financing for SMEs is critical in Hungary in order to stabilize high economic growth rates. The access of SMEs to financing in the years ahead can be further improved with the revision of regulations on VC funds which may be prepared to invest in anticipation of improved exit opportunities. In a ten-year period VC funds can grow to play an important role in Hungarian capital markets.

- Backward segments of bond markets, i.e. corporate and municipal bonds, have to be developed. Not only multinationals but large companies will divert their financing from Hungary if they do not find appropriate maturities at reasonable costs. A progress in the corporate and municipal bond markets can contribute to a more balanced financing system, which can be beneficial for productive investments, and bolsters savings and stability, when adverse shocks come. In an effort to achieve this, supportive changes are required in legal regulations as well as in market infrastructure.
- With a higher level of integration to European and global financial systems, small Central European exchanges can not maintain their competitiveness. It is expected that during the next 5 years, they will develop into a regional association of national exchanges.
- A series of regulatory changes, including a full revision of legislation on securities and investment service providers, are needed to improve investor's protection. The implementation of this might take several years. Regulatory changes have to give an incentive to the development of such services, which can contribute to a better understanding of risks by investors. These can include the introduction of the mandatory rating for several issuers.
- Analysis, rating and evaluation by shareholders, auditors and supervisors can work only on appropriate disclosure requirements. In Hungary, availability or periodicity of consolidated accounts need to be improved for credit institutions. Disclosure rules for investment service providers, however, have to be basically revised. In light of recent developments there is a need for an improvement in accounting and auditing procedures and practices.
- In Hungarian circumstances, foreign owners who are represented in the boards of directors and other supervisory boards typically provide the strategic guidance to financial institutions. This kind of corporate governance can be regarded as quite developed in comparison with other countries in the region. Laws in force, especially corporate and banking law, establish the accountability of boards but their stipulations and transparency of requirements need to be improved in the future. Laws regulate the composition of boards of banks in details. This requirement, however, has to be eased in the future, including an increased room for discretion provided in this respect to owners of institutions.
- Following the integration of banking, securities, insurance and pension fund supervisions, one of the basic supervisory challenges for the future is to establish a credibility on the level of most efficient agencies of the former institutional set up while harmonizing the different supervisory

cultures and preserving supervisory values of specialized agencies. An efficient “change management” process should be put in place. The consolidated supervision based on integrated supervisory structures needs to be enhanced and requires amendments in the legal framework as well as an improvement in the supervisory practice. Increased international supervisory cooperation has to be established in order to monitor cross-border business more efficiently. The most important challenge for supervisors in the next decade is that the traditional “compliance” approach does not work anymore. In a rapidly changing business environment, characterized by increasing financial innovations and possibilities for regulatory arbitrage, the supervision needs to be proactive and the supervisor must be sure that risks undertaken by different institutions are coupled with adequate level of risk management and capital back-up. Besides an improved regulatory framework, this requires increased cooperation in the control carried out by owners, internal and external auditors and supervisors. During the next decade, the role of self-regulatory organizations will also increase and it will become an important component in the overall regulation of market developments and behavior.

## **2. Institutional and legislative background**

Financial markets and institutions perform the very important task of channeling funds to those who have productive investment opportunities. The operation of the national economy and the resulting economic growth is largely dependent on the stability and efficient functioning of the financial system. In Hungary, the need for reform of financial markets and institutions was recognized as early as the middle of the 1980s and this resulted in several institutional and policy reforms before the beginning of the political transition (e.g. the introduction of the two-tier banking system, the establishment of the basic pillars of money market, the liberalization of interest rates). The decade of the 1990s brought new challenges: earlier policy reforms had to be revitalized and enhanced besides an increasing openness of the country in a less favorable external economic environment. This required coordinated efforts to strengthen the institutional framework in which the Central Bank, credit institutions, securities firms and other financial undertakings operate well to develop the necessary infrastructure in technology, human capital and know how.

There were several legislative steps which proved to be instrumental in achieving these objectives. The 1990-92 reforms in financial legislation resulted in the introduction of safe and sound prudential regulation in banking. It took into consideration several Basle recommendations and directives of the European Union, including comprehensive and up-to-date rules on securities business, stock and commodity exchanges. It was also supported by the enactment and strict implementation of market oriented accounting and bankruptcy rules in 1992. New foreign exchange legislation from 1996 introduced the current account convertibility of the Hungarian forint and liberalized international financial transactions in a significant extent. The 1996 Law on Credit Institutions established the basic framework for banking supervision on a consolidated basis and, in accordance with this, the former separate Banking Supervision and Securities and Stock Exchange Supervision were merged into a new supervision institution called the Hungarian Banking and Capital Market Supervision. The 1998 amendment of the Law on Credit Institutions allowed banks to provide banking and investment services under one roof and opened the possibility for universal banking. The Law on Single Supervision entered into effect on April 1, 2000 and merged the former separate Hungarian Banking and Capital Market Supervision, Insurance Supervision and Pension

Supervision in an effort to facilitate the more efficient supervision of financial groups which have become typical in the second half of the 1990s in Hungary.

## **2.1 Further harmonization with international practice, especially the requirements of the European Union**

As a result of legislative changes in the 1990s indicated above, Hungary achieved a significant level of harmonization in its banking and capital market legislation comparable to that of the European Union. Several further steps need to be taken, however, in order to reach a full compliance by the time Hungary's accession to the EU is realized. The forthcoming amendment of the Law on Credit Institutions and related modifications in the financial legislation will introduce an enhancement of consolidated supervision requirements as well as market risk capital requirements (including rules for keeping trading books) in accordance with the Directives of Consolidated Supervision and Capital Adequacy. The netting - in line with Netting Directive - has not yet been specified with details in Hungary. Here, the progress for the near future is constrained by the fact that the establishment of netting in prudential requirements assumes simultaneous changes in other legal fields, like bankruptcy legislation, where netting is not yet appropriately introduced.

The insured amount in the deposit insurance scheme and the minimum capital for savings cooperatives needs to be increased. In Hungary, anonymous deposits still exist, since these are not covered by deposit insurance - in Hungary. These deposits have to be discontinued according to the requirements of the European Union. Although regulations can be changed overnight in respect of the latter three requirements, the practical implementation will be gradual and can probably be completed only by the time of accession. The legislation allows for branching of foreign banks in Hungary. Existing rules, however, are more restrictive than the regulation required in the countries of the European Union. Present regulation maintains the capital requirements of subsidiaries supplemented with a special asset maintenance ratio for branches. Liberalization of branching would significantly influence the structure and competitive positions of the Hungarian banking system and consequently can not be expected prior to accession. The forthcoming amendments of the Law on Credit Institutions will probably include all of these stipulations up front and indicate when the specific changes enter into force.

## **2.2 Full compliance with Basle Core Principles**

Hungary has achieved good compliance with the Basle core principles in general. Specific areas where the compliance continues to be insufficient mirror the problem areas of the compliance with the directives of the European Union i.e., the need for the enhancement of supervision and the enforcement of prudential rules on a consolidated basis, as well as the measuring, capturing of market risk (and the risk management process) and the use of specific capital charges against this. Other areas of insufficient compliance are set out below according to findings of an assessment prepared by the HBCMS, and taking into consideration the remarks of the World Bank and IMF in a recent Financial Sector Assessment Report:

- The supervisory right to exercise regulatory powers needs to be re-established in order to ensure quick regulatory responses to market developments and violation of rules. Although the need for this is not denied categorically by anyone, there is no understanding among the institutions interested in the regulation and enforcement on how to implement this requirement in practice.

- The evaluation of banks' policies, practices and procedures of loan granting. Other investments and management of loan and investment portfolios have to be strengthened, especially in terms of the evaluation of management responsibilities. Regulations and enforcement of connected lending are expected to be stricter. These requirements can be treated partly through the forthcoming amendments of the Law on Credit Institution and the tightening of the supervisory practice.
- The possibilities for corrective measures against regulatory violations and the enforcement of corporate governance in financial institutions need to be enhanced. There have been several proposals for the forthcoming amendment of the Law on Credit Institutions, in order to increase the flexibility of the supervision. Tightening of the supervisory practice, however, is also required.
- The efficient contribution to the consolidated supervision of internationally active banks needs an improved cooperation, including the conclusions of MOUs among supervisory authorities of partner countries. MOUs have been signed with several securities supervisions. The legal framework for this in Hungary is in place, but no MOU has been concluded with foreign bank supervisions. An important task for the Hungarian authorities in next couple of years will be the establishment of an active cooperation with bank supervisory authorities of the EU members and other important partners in international financial transactions.

### **2.3 Amendments of Legislation as needed, based on recent market developments and regulatory experience <sup>1</sup>:**

- Harmonization of different fields of financial legislation:* Different fields of financial legislation were drafted and enacted at different times and later interpreted and developed on their own. The introduction of the "single supervisor" - with the aim of efficient consolidated supervision of financial groups - reveals that supervisory procedures are very different for banks, securities firms, insurance companies and pension funds. Consolidated supervision requires harmonization of these to a considerable extent. Prudential requirements remain highly influenced by sector specifics but some harmonization is possible in this area, too. Reconciliation is needed among the separate pieces of legislation for collective investment products like mutual/pension funds and certain life insurance products. Moreover, reconciliation is required between the provisions of the Corporate and Securities Laws referring to the same or related issues of regulation, e.g., provisions of concern law or take-over rules.
- Revision of Law on Securities:* The reason for this comes partly from the introduction of universal banking. Originally, provisions of this law were applied to investment service providers, i.e. brokers, dealers and underwriters). Following the introduction of universal banking, provisions were used equally on banks which offered investment services. Another reason is the need for financial strengthening of investment service providers in light of failures following the Russian crisis as well as the introduction of stricter regulatory requirements which promote investor's protection, including better disclosure and reporting rules. Regulations on cross-border activities need to be enhanced also. Newly developed, special activities like inter-dealer/discount broker have to be recognized and covered by the Law.

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<sup>1</sup> This section draws on the recommendations prepared by a working committee established for the improvement of capital market regulation, headed by Mr. Zoltán Pacsi (The Concept of Improvement of Capital Market Regulation, April 30, 1999).

- c. *Revision of Law on Bond Issues and Related Regulations*: Stipulations of this law need to be revised in an effort to facilitate the development of the rudimentary corporate and municipal bond markets (see later in 6.1). This requires the removal of the restriction which limits bond issues for companies (except for credit institutions), in the amount of their shareholders' equity. The improvement of the regulation on continuous issues, bond programs, etc., which have become more frequent and important is also required.
- d. *Modernization and unification of rules on exchanges*: There is a general professional support for the replacement of the present segmented, *sui generis* regulations on exchanges with unified rules based on profit oriented corporate form.
- e. *Improvement of regulation on collateral and taking possession of collateral*: This can be a catalyst in real estate and SME finance and would increase the safety in payment and settlement systems.

### **3. Reduction of remaining structural vulnerabilities of banking system, facilitating its integration with global markets**

In the beginning of the 1990s when Hungary lost a considerable part of its traditional markets due to the collapse of the CMEA, a simultaneous enforcement of stricter accounting, bankruptcy and prudential banking rules - loan classification and provisioning - accelerated the necessary structural changes in the economy and inevitably led to an abrupt increase in the stock of non-performing loans in the banking system. Part of these already accrued in earlier years as a consequence of inexperience in credit evaluation and collateral management. Another - probably smaller - part, however, was related to the ongoing difficult market conditions. The stock of non-performing bank loans became very large by the end of 1992 in comparison to the banking sector's total equity capital, and several large banks were forced to seek capital replenishment to an extent which appeared out of their reach. In an effort to avoid the expansion of a systemic banking crises, the government decided to launch a bank rehabilitation program. The rehabilitation program of 1993-1995 covered the troubled banks as well as their large debtors. These banks were rescued partly through the restoration of their loan book and partly through direct capital infusion following the submission of restructured recovery plans to the government institutions responsible for the bank rehabilitation. As a consequence of this, capital adequacy returned to the level of statutory minimum which corresponded to the Basle minimum requirements. In essence the total cost of this program amounted to about 10 percent of Hungary's 1993 GDP.

Table 1

### Cost of Resolving Banking Sector Problems in International Comparison

Country and time period of problems	Estimate of total costs as percentage of annual GDP of restructuring period
Latin America	
Argentina (1980-82)	13-55
Chile (1981-85)	19-41
Mexico (1995)	15-17
Venezuela (1994-95)	17
Transition countries	
Bulgaria (1990s)	14
Hungary (1992- 1995)	10
Industrial countries	
Finland (1991-93)	8-10
Japan (1990s)	3
Spain (1977-85)	15-17
Sweden (1991-93)	4-5
United States (1984-1991)	5-7

Source: Crockett, Andrew "Why is Financial Stability a Goal of Public Policy" Maintaining Financial Stability in a Global Economy, Symposium Sponsored by the Federal Reserve Bank of Kansas City, Jackson Hole, Wyoming, 1997 and IMF World Economic Outlook, 1998 May, page 78.

As described above, the legislative steps taken, coupled with the bank's rehabilitation program by the government and the restructuring activities carried out by its management, resulted in the opening up of the Hungarian banking system to foreign strategic participation to integration to the European and global financial markets. Following restructuring and re-capitalization, banks were mostly privatized, typically through sales to foreign strategic investors. By the end of 1999, banks under foreign control represented a 65 percent share from the total registered capital of the Hungarian banking system. The share of the public sector in the registered capital of credit institutions was reduced to 19 percent.

These changes have contributed to a more transparent owner's structure. The professionalism of management has normally increased in banks with foreign strategic investors and reflecting a deeper experience of foreigners in banking coupled with local familiarity with market circumstances. Management's motivation has also changed; their lending practices have been revised and internal and external audit systems have improved in general. At the outset, restructured banks

remain risk averse and concentrate their traditional lending activities mainly to blue chip customers. Fierce competition drives them toward middle markets and the innovative fee-based business has a growing importance while human factor rapidly appreciates in this process.

Where owners' control on bank activities continue to be weak, and corporate governance and external audit insufficient, the supervision authority lacks efficiency in conducting supervision on a consolidated basis and bank losses remain hidden for years. The case of Postabank in 1998 illustrates that a mismanaged privatized bank without appropriate control can accumulate such losses, and raise the threat of systemic consequences by forcing the Government to seek a very costly rescue action.

In spite of the widespread portfolio cleansing, hidden inherited elements may remain in loan, securities and real estate portfolio of privatized banks - and when revealed - need to be covered by provisions, or written off. Owners have to accept these consequences in the form of additional capital. Deferring the capital infusion in very competitive market circumstances, like the present one in Hungary, might lead to compounding difficulties partly through the delay in restoring confidence.

Another challenge for Hungary's future is the frightfully increasing operational risk due to an outdated and segmented information technology, and concomitant unreliable management information systems in the case of some medium-size and large banks. These banks are forced to undertake very high costs in order to accelerate investments and catch up to the level of the system development of competitors.

Any remaining structural problem of banks might prove to be a serious competitive disadvantage and even disastrous when integration with the EU financial system will increase to a higher level.

#### **4. Financial sector depth and concentration**

##### **4.1 Banking sector**

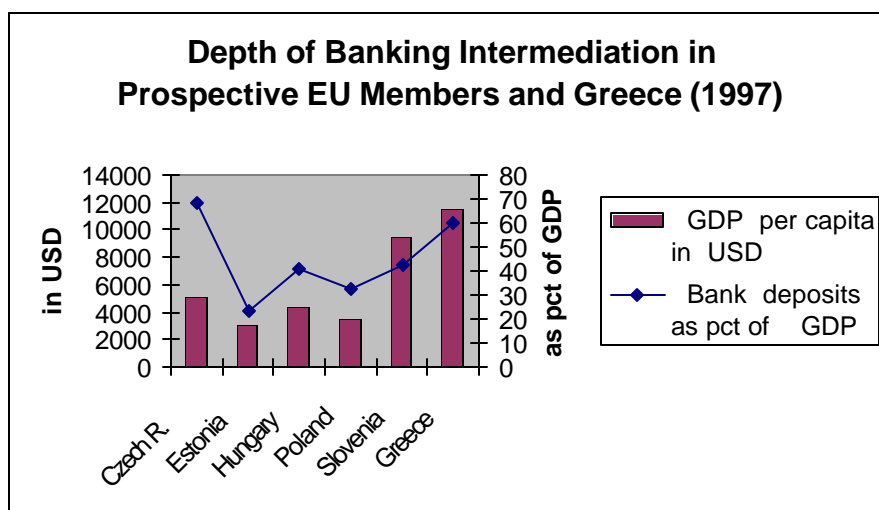
By the end of 1999, credit institutions in Hungary numbered 260, of which 43 operated in the form of joint stock entities and 217 in the form of cooperative institutions (savings and credit cooperatives). In recent years there has been a tendency for increasing concentration, and both the numbers of joint stock banks and cooperative institutions declined. Ten major banks represent 73 percent of the total banking activities at present. The concentration is more striking in the retail sector where the National Savings Bank (OTP) has a dominant position and ten major banks control about 90 percent of the market.

The concentration process is expected to continue. In the cooperative sector, bank regulation promotes further concentration with a gradual increase capital requirement to the level of the European Union. As regards joint stock banks, it appears that in the case of the privatization of the remaining two commercial banks - which are under direct state control at present - a considerable demand would arise from those banks which already operate in Hungary. Hungary's entry into the European Union most probably sets a further wave of consolidation in motion - the direction of which will be influenced by the overall developments of bank mergers in the European market. The reasons for these mergers will be basically the commercial banks' efforts to improve cost savings under competitive pressures, and the geographical and functional diversification of their activities as

well as efforts to achieve the appropriate size in order to increase profitable activities and sustain a competitive edge in a larger and unified market.

The degree of financial intermediation carried out by the banking system can be measured by the ratio of bank deposits to GDP. This ratio was 44 percent at the end of 1999 and during the period of 1995-1999 – it demonstrated only a modest average annual growth increasing from the 40 percent level. The ratio is apparently low in Hungary compared with member countries of the European Union as well as with a few Central European countries like Czech Republic or Slovenia. The reason for this is the level of per capita income, like the regional distribution of economic activities (inequalities) and the urbanized character of society which largely influence the density of bank branches and the use of bank services. In Hungary, a number of bank branches per million inhabitants for instance, falls well behind that of Western European countries. In broader international comparison the degree of banking sector depth appears to be low relative to the economic development Hungary has achieved.

Chart 1.



Source: Bank Profitability OECD 1999, IMF International Financial Statistics

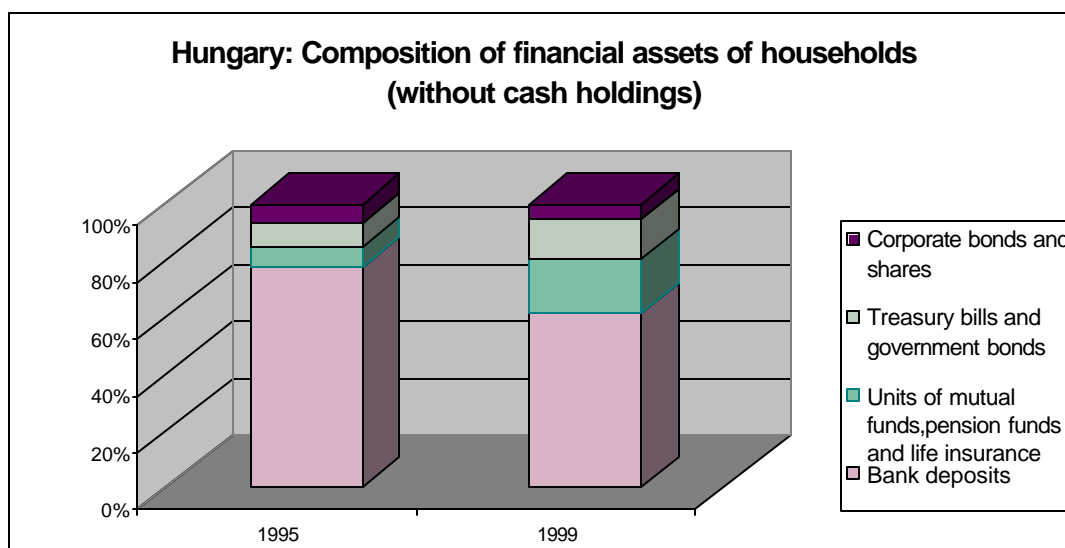
Hungary has a higher level of banking sector intermediation than most of Eastern Europe and countries of the former Soviet Union. This divergence in terms of banking sector depth has been considerably influenced by the level of inflation and a period of high inflation experienced during the 1990s.

## 4.2 Institutional investors

Following the 1995 stabilization program, economic growth revived and accelerated, and meanwhile inflation declined steadily in Hungary. With this background, one would expect a strong increase in the degree of financial intermediation carried out by the banking sector, reinforcing

economic activities in the country. This was, however, also the period when mutual funds' units and contractual savings (especially in pension schemes and life insurance products) began to grow in Hungary markedly which, in turn, brought about - while the volatility of prices remained reasonable - a considerable increase in demand for corporate shares and longer term government bonds also. The growth of institutional investors (mutual funds, pension funds and insurance companies) offering investment funds' shares and contractual savings could give an explanation why the degree of banking sector depth - measured by the ratio of banks deposits to GDP - showed a lower growth than normally expected in circumstances prevailing between 1995 and 1999. The share of claims of the household sector in the form of mutual fund's units and contractual savings increased from 2.2 percent in 1995 to 7.9 percent of GDP in 1999. Throughout the period this also contributed to an increase in market capitalization, volume traded, depth and liquidity of capital market.

Chart 2.



Source: National Bank of Hungary Monthly Report, 2000 February

Based on these trends, it can not be expected that in the medium term there would be a large abrupt - catching up increase - in the level of intermediation through the banking system. It is probable that the real growth of deposits will be faster than that of GDP and banking sector depth will increase gradually from the present low level. The share of mutual fund investments and contractual savings compared both with total financial assets and GDP continues to grow. The speed will be significantly influenced by availability and extent of tax incentives as well as the regulation of the level of contributions to the compulsory fully funded pillar of the pension system. This means that due to the availability and the development of securities markets, companies can rely in financing of the probably rapid capital accumulation more on equity and bond issues toward investors than on debt financing from the banking system. The capitalisation, depth and liquidity of capital markets are expected to grow significantly. When investors can raise financing through issuing equity and bonds at lower cost than the cost of bank financing, banks have to respond with services which result in the increase of their off balance sheet non-interest income.

### 4.3 Widest possible range of financial services

Until 1999 Hungarian banks could not apply for license for full-scale investment services. They could offer, however, these services and also insurance through separate subsidiaries. They established subsidiaries for other financial or supplementary financial services like financial leasing, factoring etc., as well as organized activities on different support services to the basic banking business as separate undertakings (e.g. building maintenance, security or delivery of banknotes). With this regulatory background, banking and financial groups have emerged which mean companies under common control whose predominant activities consist of providing banking and investment services (brokerage, trading and investment banking) as well as leasing, factoring, insurance, fund management and pension fund services. Pension funds themselves are organized as mutual societies and do not belong to the financial group. All related services to pension funds, however, are provided by subsidiaries in the group. The largest banks typically have subsidiaries for nearly all of these services in their groups (the insurance, however, being the least frequent). In the case of medium and smaller size banks, the provision of investment services through separate subsidiaries have been very frequent (most banks - except specialized ones – have their own securities firms). From the beginning of 1999, several banks have received approval from the Supervision for the provision of investment services directly. Some of them have already merged the separate subsidiary for investment services with the bank.

Bancassurance activities are carried out in different forms. At present 8 joint stock banks and majority of savings cooperatives have received approval from the Supervision to sell insurance products as agents of insurance companies. Insurance companies are mostly members of the same financial groups where banks belong to and typically the bank is the main operating company of the group. At the same time, five banks use insurance companies as agents for selling their banking or joint products.

Banking and financial groups have usually originated in bank efforts' to offer a wider range of financial services and respond to changes in the structure of savings of their clients. It is expected that the successful large banks and some of the medium-size banks (altogether 6-8 banks) continue to move in this direction and offer in their group – beside bank deposits – wide range of investment funds units at different level of risk as well as contractual savings opportunities. On the other side, they provide financing – besides bank lending – in different forms, including leasing, factoring. Institutional investors in groups can invest in different securities and contribute to a more balanced corporate and household financing structure, especially through increasing the availability of long term funds. Commercial banking, investment banking, fund management and insurance are already concentrated in a significant extent within the existing groups around these banks and this concentration will increase further in the future.

Other small and medium size banks – including specialized institutions as mortgage and home saving banks - will be partly taken over by the dominant groups and partly transformed into branches of foreign banks when legal provisions on branching will be eased. With the increasing familiarity with and access to electronic banking from major international banks, the viability of savings cooperatives over the next ten year period is questionable even with improved capital strength and institutional framework.

Banks have already made substantial investments in the development of Internet banking in Hungary. Banks typically own these facilities themselves. Internet banking is suitable to supplement branch network and - in prospective – even to replace it. It will be also a typical way in future to offer financial and investment services abroad; therefore it can be an alternative for cross border mergers. It appears that besides households there is a remarkable increase in demand for on-line services in small and medium size business where cost and time saving nature of these facilities is promptly recognized. The challenge for supervisors in this field that several elements of this progress is out of supervisory oversight. Supervisors have to study and understand the process, estimate the speed and scope of expansion, respond with appropriate explanation to customers as well as regulations to mitigate emerging risks.

Joining the Euroland and using the TARGET, the importance of the correspondence banking and the documentary business will be reduced since an overwhelming part of banking transactions are conducted with these countries. It is apparent that banks already compose their budgets with a consideration to this development.

## **5. Soundness of the Banking System: present and prospective**

### **5.1 Structure and growth of banks' assets**

The 1993-95 bank rehabilitation and the subsequent 1995 economic stabilization program - through the more stringent lending practice, high real interest rates and initially declining domestic demand - had a negative impact on the ratio of outstanding bank loans to GDP. The ratio declined from 28 percent to 25 percent in 1996 then recovered slightly in 1997 and 1998. The share of loans accounted for 40 percent of total assets of credit institutions in 1997 and 1998, securities holdings with trading or investment purpose constituted about 20 percent of assets, while claims on the Central Bank and other banks gave about 29 percent of assets during these years. Relying on Central Bank exchange and interest rate policies, banks could count on low risk profit making possibilities on the conversion of their foreign currency funds to government securities and Central Bank instruments denominated in national currency. Money and exchange market conditions became less predictable after the Russian crises. Several banks suffered losses through their subsidiaries involved in securities business. The resulting profit squeeze by the end of 1998 forced banks to revitalize their lending activities toward the corporate and household sectors. In 1999, the ratio of loans to GDP increased to 30 percent, reflecting a 16 percent increase in loans outstanding in real terms. In the structure of banks' assets, the share of loans increased to 44 percent while the share of securities showed a corresponding decline to 16 percent. In years ahead, the loan/GDP ratio and the share of loans in total assets are expected to grow further. Their present level is fairly low in international comparison. Although in this framework alternative (not bank debt) financing opportunities for the corporate sector are available in perspective, a sharp increase in ratios is not excluded either, since the share of households in the total credit stock is very low and due to better prospects in their income position, a large increase is expected in the household credit demand which will be basically satisfied from credit institutions.

## 5.2 Quality of asset portfolio, profitability and capital adequacy

As a result of the portfolio cleansing during the period of bank rehabilitation program and individual rescue actions as well as the cautious lending activity, the loan portfolio of banks operating in Hungary is very sound. In 1999 and so far in 2000, the share of bad components from the total assets remained below 2 percent. At the end of 1999, the share of sound items was 92.1 percent from total assets. As regards the remaining, the share of items, which needed special attention, was 4.5 percent from total assets, substandard and dubious components contributed with 2.3 percent, while bad items gave only 1.1 percent. Although the management expertise and credit evaluation methods have improved, the turn toward middle markets, small business and households and the acceleration in lending activities altogether most probably will result in the increase of problem items from total assets as well as in the increase of bad components from total qualified items in years ahead.

Table 2.

<b>Hungary: Banking System</b>									
	<b>Concentration</b>				<b>Profitability</b>				<b>Number of Loss Makers</b>
	<b>Number</b>		<b>Market share %</b>		<b>ROA %</b>		<b>ROE %</b>		
	1998	1999	1998	1999	1998	1999	1998	1999	
<b>Large banks</b>	10	10	72.8	72.8	-1.9	0.8	-24.6	11.1	2
<b>excluding Postabank</b>					1.4	0.9	15.9	11.4	
<b>Medium-sized banks</b>	9	9	16.4	17.4	0.4	0.5	4.6	6.1	2
<b>Small banks</b>	12	10	5.1	4.3	-4.0	-0.7	-28.1	-5.1	6
<b>excluding Realbank</b>					-0.5	-0.7	-3.4	-5.1	
<b>Specialized institutions</b>	13	14	5.7	5.5	-12.8	0.5	-5.9	-1.2	7
<b>excluding MFB</b>					-3.0	-0.5	-15.3	-3.3	
<b>Banking system</b>	44	43	100.0	100.0	-2.2	0.7	-24.7	8.0	17
<b>excluding removed banks</b>					1.0	0.7	10.6	8.3	

Notes: (1) Postabank was recapitalized by the Government in 1998. The bail-out was partly undertaken by the MFB (Hungarian Development Bank) Realbank failed in 1998. (2) Figures in Table 2 do not cover saving and credit co-operatives.

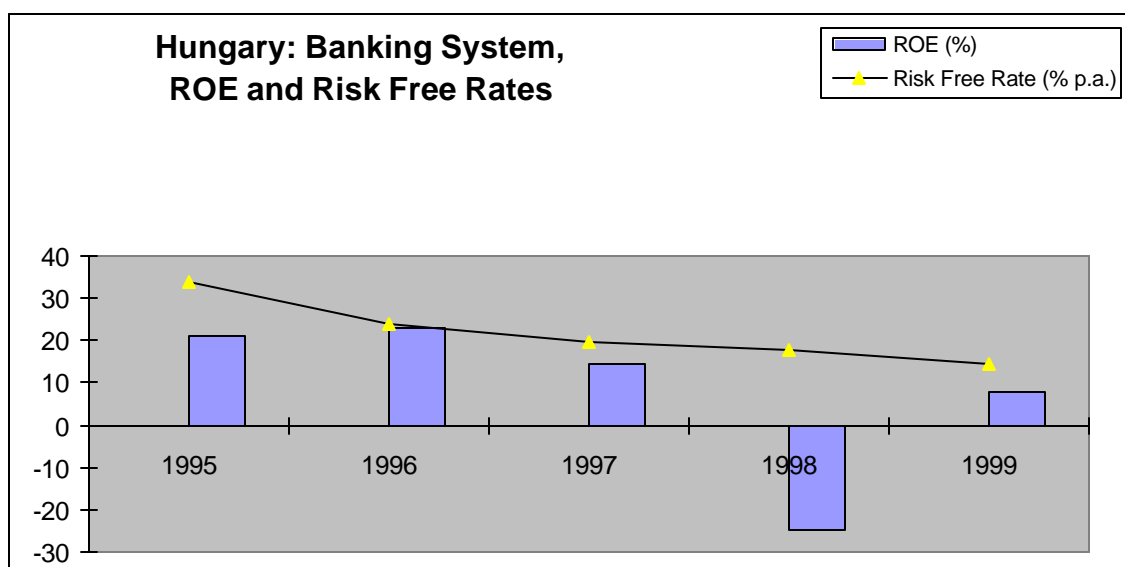
Source: Annual Reports of the Hungarian Banking and Capital Market Supervisions, 1997-99

Profitability of credit institutions in 1997 was characterized by 1.3 percent ROA and 14.6 percent ROE in Hungary. Profitability turned into negative in 1998 due to revealed losses at Postabank and Realbank as well as losses suffered at several other banks through their subsidiaries in securities business. In 1999 both ROA and ROE improved compared with 1998 but indicate a decline compared with 1997, ROA and ROE being 0.7 percent and 8 percent, respectively. The major reasons behind the decline in profitability has been the dezinflation, the concomitant decline in nominal interest rates and a parallel decline in interest margins due to the sharp increase in banking competition. At the same time, there is no apparent improvement in cost efficiency either, which in 1999 can be explained by efforts of banks to expand their retail network as well as by expenditures on system development connected with Y2K problem. In future, interest margins remain under

pressure since competition continues to be fierce and additional pressures come with the deeper integration of the Hungarian financial system with that of the European Union. Banks who can improve their cost efficiency and expand fee-based business (partly through increased securitisation) can be successful in maintaining or increasing profitability performance. During the next two years the provisioning expense for loan losses does not constitute a significant burden on earnings, later this can be a more important factor in earnings performance.

The capital adequacy ratio (consistent with Basle guidelines) showed a declining trend reflecting both the acceleration of higher risk lending and decreasing profitability of credit institutions. This ratio was 17.5 percent in 1997 and declined to 14.2 percent in 1999. The present level of capital adequacy provides room for further risk taking in the banking system in general in the medium term. Foreign strategic partners declared their readiness for further capital infusion in case of need. Despite this, the expansion of the activity of certain banks may be constrained temporarily by insufficient capital base.

Chart 3.



Source: Annual Reports of the Hungarian Banking and Capital Market Supervision 1997-99 and Monthly Reports of the National Bank of Hungary

## 6. Need for Changes in Areas of Inadequate Finance

Beside achievements, there have remained issues with financing specific sectors: these include real estate finance and home construction by households, small and medium size enterprises, agriculture producers and municipalities <sup>2</sup>:

### 6.1 Real estate, especially housing finance

<sup>2</sup> This section draws on the remarks of the Financial Sector Assessment prepared by the World Bank and IMF with respect to SME and municipal financing. The issue of real estate finance, however, is placed in a different perspective.

In recent years credits to households accounted for about 10 percent of total credit stock and half of total credits to households financed home construction. Following the termination of the system of subsidized housing loans of the former economic regime; stock of housing loans showed a steady decline due to high financing costs. The overwhelming majority of housing credit stock has remained with the National Savings Bank (OTP) which – until recently – was practically the only player in the market. There have already been efforts in financial sector legislation, which have addressed these issues. Laws on home savings banks (in line with the German Bauspar model) and mortgage banks (also in line with the German mortgage bank model) were enacted by Parliament two years ago. Four home savings banks and two mortgage banks have started operations. Home savings are, however, basically in the stage of accumulation of pre-savings and they do not lend for home construction yet. Mortgage banks are the only institutions, which can issue mortgage bonds. At the beginning of their operation they wished to concentrate mainly on the finance to commercial and industrial real estate. Products of home savings institutions include pre-announced government subsidies for home construction. The Government wished to accelerate the home construction and therefore selected – as a Government supported institution - one of the mortgage banks from the beginning of 2000 as channel for the provision of new subsidies for home builders and also for a basic institution of the secondary market for mortgages. This mortgage bank has contracted with commercial banks, insurance companies and savings co-operatives in an effort to expand the provision of housing loans under the new subsidy scheme. Besides channeling subsidies, the Government supported mortgage bank provides liquidity to primary market lenders and improves market efficiency through moving toward a standardization of mortgage lending. Having this special government supported status; the selected mortgage bank enjoys a better market standing. Purchased loans are kept in the portfolio of this bank and financed by issuing mortgage bonds. The new arrangement has provided an incentive for borrowing and – with the establishment of the secondary mortgage market – also for primary lending.

With the enforcement of this new arrangement, however, the long-term viability of home savings banks may become questionable. It means also a deviation from the original model of mortgage banks and creates competitive distortions in this sector. These anomalies need to be redressed and a sound way for system development needs to be established.

## **6.2 Financing for SMEs**

Although some years ago there was general shortage in credits to SMEs in Hungary, medium size enterprises' access to credits has improved recently. The increased competition and the profit squeeze have driven banks toward middle markets and this has been supported by new institutions which moderated lending risks of banks (credit guarantee funds, credit information systems) and also by new instruments like public warehouse warrants which were mainly used by agriculture producers as a collateral for their short term credit requests. Lending to small enterprises, however, continued to be insufficient compared with the economic importance of this sector. Credits to small enterprises accounted for only 3-4 percent of total credit stock, while this sector gave more than 10 percent of GDP. The access of SMEs to financing in years ahead can be further improved with revision of regulations on VC funds which may be prepared to invest in anticipation of improved exit opportunities. VC funds can provide valuable support to firms with their expertise in strategic planning, marketing and accessing complementary financing. Regulations on taking possession of collateral need to be made more flexible, the registration of liens as well as system of credit information have to be improved in Hungary.



### 6.3 Municipal financing

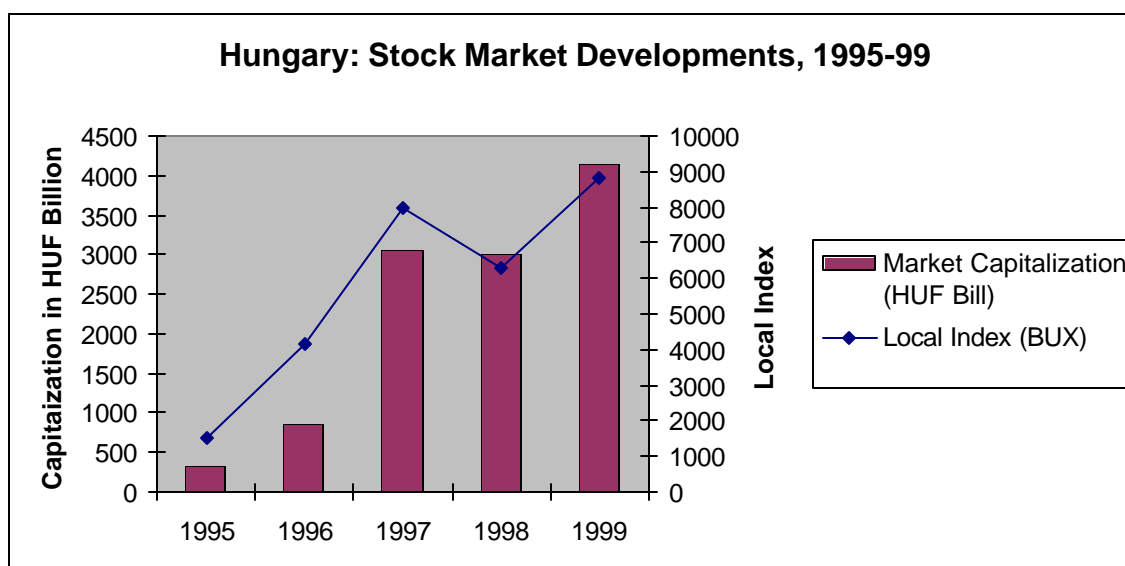
During recent years credits to municipalities accounted for about 1.5 percent from the total credit stock of the banking system. The amount of their deposits exceeded significantly the amount of their credits. Municipalities belong to the clientele of very few banks. Municipalities with idle funds take also the portfolio management services of securities firms. At present the public sector borrowings are centralized. Municipal bond markets – which existed earlier in Hungary – need to be revitalized if longer-term financing need arises on a massive scale in connection with local development projects. The revitalization of municipal bond market requires the revision of provisions of the present Law on Bond Issues. Since local rating agencies already provide services in Hungary, the introduction of mandatory rating requirement for municipal bond issues is possible. Municipal bond rating would help investors to estimate the risk they undertake with new issues and continuous monitoring done by rating agencies would provide additional information on later developments in financial position of municipalities.

## 7. Capital markets

During the 1990s a modern capital market infrastructure has been developed in Hungary, which – together with favorable macroeconomic developments – has contributed to a significant increase in the participation of foreign investors in Hungarian markets.

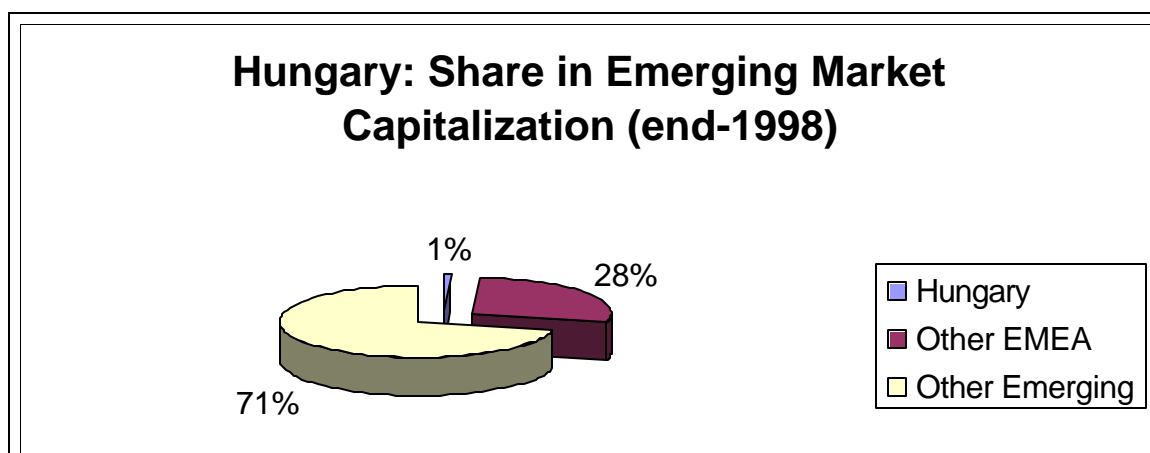
### 7.1 Structure and growth of equity and bond markets

Market depth and liquidity has grown considerably since the successful stabilization program in 1995. Market capitalization of the Budapest Stock Exchange expressed as share of GDP increased from 21.7 percent in 1995 to more than 63 percent in 1999. Equity capitalization during the same period grew from 5.8 to more than 36 percent of GDP.



Source: Annual Reports of Hungarian Banking and Capital Market Supervision, 1997-99

The equity turnover ratio - indicating the liquidity of exchange – exceeds 110 percent (17 percent in 1995) and with this level Hungary took 8. place among 90 countries based on the ranking of the IFC in 1998. The high turnover ratio in international comparison can be regarded as an attractive feature for foreign investors. At the end of 1999, 79 percent of corporate stocks traded in the Budapest Stock Exchange was in hands of foreigners, while their share in government bond holdings was 17 percent. The increase in market capitalization and liquidity, however, was concentrated in a few companies. The 10 most active index stocks had more than 80 percent share from the total value traded in 1998. With this level, Hungary was among those emerging market countries which had the highest market concentration (Argentina, Pakistan and Russia with 89, 96 and 86 percent concentration, respectively). This means that all market participants have not equally shared benefits of rapid market progress.



Source: Emerging Stock Markets Factbook 1999, IFC

The turnover of public OTC securities trade have also progressed much but it has become increasingly a government securities market for small domestic investors. The market for government bonds has dominated bond markets in Hungary. Government bond issues are well organized, managed by the Government Debt Office with the support of primary dealers. These include long term issues up to ten years maturity and benchmark issues cover basically the whole range of yield curve facilitating the pricing of long term securities. Corporate bond markets are underdeveloped and municipal bond markets are practically non existent.

The market infrastructure has developed to a fairly high level in Hungary. The open outcry trading in the Budapest Stock Exchange has been replaced with computerized order-driven automatic matching system. Relatively fast and reliable clearing and settlement systems have been introduced with the support of a Central Depository.

A major challenge for the years ahead is the development of corporate and municipal bond markets. With the strengthening of corporate bond markets more balanced corporate financing structure can be achieved with reduced cost of capital. More developed bond markets can reduce the burden on the banking sector and in the case of a banking distress; they can take over the task channeling funds from savers to productive investments. With increasing the variety of saving instruments they bolster and increase of the level of savings.

In Hungary the progress in this field requires a further improvement in market infrastructure (trading and settlement), changes in regulatory and legal framework (see 3.1 c and 6) and more

reliance on credit rating agencies (in certain market segments the introduction of mandatory rating seems to be necessary).

With a higher level of integration to European and global financial system, small Central European exchanges can not maintain their competitiveness. It is expected that during the next 3-5 years, they develop into regional associations of national exchanges.

## **7.2 Investors protection**

Following the Russian crises, the fall in prices of securities had a negative impact on investment service providers (brokers, dealers and underwriters). In 1998 and 1999 operations of 27 companies were suspended, their licenses were mostly revoked by the HBCMS. The basic reason for this was that the increased volatility of asset prices revealed that in the case of several investment service providers the management of assets of firms and their clients was inappropriate which remained hidden during the previous period when this sector benefited strongly from the significant increase in asset prices. Accounting rules were not complied with, moreover there were no appropriate internal control procedures, and occasionally there was no internal control at all. Firms' own funds and clients' funds were not separated which resulted in increased possibilities for fraud. In Hungary an Investors Protection Scheme operates, funded by investment service providers which gives compensation with an upper limit to clients of failed companies. Funds of this Scheme, however, have proved to be insufficient compared with the sharply growing claims of customers.

In an effort to increase investor's confidence a series of regulatory measures are required. The minimum capital requirements need to be increased for those activities where the risk undertaken justifies this. In light of previous failures, disclosure requirements need to be strengthened; the content and periodicity of reporting requirements have to be revised. A supervisory early warning of problems in financial health of investment service providers need to be established and on-site examinations by the supervisory authority have to be organized accordingly. On and off site supervisory examinations should pay attention regularly to the separation and availability of clients' funds. Regulation needs to be introduced on the enforcement of the use of back office operations and internal controls as well as the risk monitoring at investment service providers. In order to support the possibility of investors to evaluate the riskiness of activities of investment service providers, the available services of local rating firms have to be used (the Supervisory authority can give a special incentive for this).

## **8. Disclosure and corporate governance**

As already indicated about two-thirds of the registered capital of credit institutions in Hungary are in the hands of foreign investors which are mostly major players in international financial markets. Since the majority of foreign owned banks have subsidiaries in securities business, fund management, leasing and factoring, the dominance of foreign ownership can be considered typical in the financial sector overall. Foreign owners are represented in boards of directors and supervisory boards of financial institutions. They monitor operations and decisions regularly.

The equitable treatment of shareholders is ensured in Hungary. Rights of minority shareholders have not raised major issues so far.

Strategic guidance for financial institutions is provided by foreign owners (this is examined by the Supervision during the course of regular on site inspections). Boards are capable for the effective monitoring of management, although this – in a transitory economic environment - improves by learning by doing. Laws in force establish accountability of boards (especially corporate law and banking law) but stipulations of laws and transparency of requirements need to be improved in the future. The Law on Credit Institutions regulates in details the composition of boards of banks (executive and non-executive members, residents and non-residents). This requirement, however, has to be relaxed in the future and an increased room for discretion provided in this respect to owners of institutions.

The cross ownership between banks and non-financial companies is limited by law and can not be considered a major issue in Hungary for the future (It is worth to mention that before the restructuring of the Hungarian banking system – during the period of 1987-92 – the cross ownership between banks and non-financial enterprises was extensive with the usual negative consequences. Not transparent cross ownership between banks and other undertakings providing financial and investment services in banking groups have, however, significantly contributed to the recent two bank failures - Postabank and Realbank - in Hungary. The regulatory response for this was the strengthening of the framework for the consolidated supervision.) Intra-group transactions – including foreign members of groups- especially guarantees need an increased supervisory attention and co-operation too.

Financial disclosure to shareholders and wider market as well as reporting to the Supervisor is regulated and carried out reasonably well in Hungary for credit institutions. Here the availability of consolidated accounts needs to be improved. As it was already indicated, the disclosure for investment service providers has to be basically revised. In light of recent developments there is a need for an improvement in accounting and auditing procedures and practices. It is also imperative that institutions in the financial sector – both public and non public companies - should give more regular and accurate reports to wider market on their financial performance.

## **9. Supervisory structures**

### **9.1 Towards universal banking with separate capital requirements**

Banks which have applied from the beginning of 1999 for authorization from the HBCMS for the provision of investment services had to comply with the supervisory requirement of separating activities conducted on their own and on behalf of their clients as well as separating trading and portfolio management activities from other banking business, moreover creating transparent information flows and protecting certain information. Their business, however, is not divided up to banking and securities, and specific risk related capital adequacy requirement for each part of the business is not computed yet (when banks undertake securities business through separate subsidiaries, subsidiaries in securities business should correspond to a specific capital adequacy requirement compared with the aggregate value of risk they undertake). When the number of banks having this authorization increase and their investment service provision expand a separate capital model will need to be applied. This raises the issues of how banks will respond with the transformation of their traditional loan portfolio (through securitisation) in order to achieve a lower capital requirement.

### **9.2 Consolidated supervision based on integrated supervisory structures**

The increasing complexity of financial business in rapidly growing financial groups in Hungary has created the need for integration of banking, securities, insurance and pension fund supervision. The new integrated supervision faces several challenges for the future. The most important is to establish a credibility on the level of most efficient agencies of the former institutional set up while harmonizing the different supervisory cultures and preserving supervisory values of specialized agencies. An efficient “change management” process should be put in place. The possibility for the consolidated supervision for banking groups (except for insurance activities) and the extension of the consolidated supervision on insurance activities will be included in the forthcoming amendment of this law. An appropriate way of consolidation of an insurance subsidiary with parent bank, however, remains to found and the connected specific regulatory requirements need to be elaborated.

### **9.3 Increased supervisory co-operation, monitoring cross - border business**

So far cross-border activities have not created a major supervisory concern. Hungarian banks have not been active in opening foreign branches or subsidiaries and the Hungarian legislation have not given incentives to foreign branching in Hungary. Cross-border activities, however, can be a major supervisory challenge in years ahead. Banks operating in Hungary recently began to play an apparent role in intermediating funds between their mother bank and third country customers in the European Union. Foreign investment funds can offer their products in Hungary from July 1, 2000. Steps need to be taken to liberalize branching in Hungary and Hungarian banks – due to the fierce competition in domestic markets – are more eager to find foreign market opportunities. The efficient monitoring of cross border activities (especially for large financial groups operating between sectors across borders) needs the co-operation of supervisory authorities and this co-operation has not yet even started in the field of banking. The development of on-line services (for financial and investment

products) across borders constitute a coordinatory supervisory challenge as well. Finally, it is worth noting that with the emergence of single (consolidated) supervision on a larger scale internationally, the co-operation between supervisions and central banks will have a growing importance in future.

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