

3.6

Financial Services Sector

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Introduction

As with any sector in an emerging economy, the financial services sector has undergone massive change in recent years and this change is far from over, although Hungary did make more progress sooner than many of its neighbours. Hungary has attracted the highest level per capita of FDI in the region and a considerable amount of this investment has been in the financial services sector. Privatization of the banking and insurance sectors started early and was very successful in attracting foreign strategic investors.

It remains a common misconception that the Hungarian currency (forint, HUF) is in some form restricted. This is not the case as the forint has been fully convertible for some years.

Banks

The Hungarian banking sector has over 40 banks, with the vast majority being either fully or partly owned by foreign banks. The sector is already undergoing consolidation as a number of the foreign-owned banks merge or sell their Hungarian operations to competitors. The top six banks control approximately 60 per cent of total assets in the banking sector.

As in other countries in this region, many of the banks are competing in the same sector and the majority of foreign banks initially focused on foreign companies operating in Hungary and the larger local corporates. Competition has been very fierce, particularly in the larger corporate sector, and this has resulted in a number of banks now looking at smaller corporates and the retail sector. It is this competitiveness and the 'over-banked' situation in Hungary that is the driving force behind the change of focus, but some consolidation is the result of the mergers and acquisitions of the parent banks on a global or regional scale.

Overall, the banking sector is both well developed and sophisticated and can be seen as the most advanced in the region. It offers the vast

majority of products and services that would be expected in any developed market economy. Telephone banking is widely available and Internet banking is being introduced by many banks. Indeed, some very good services are routinely available in Hungary that are not available in the United Kingdom at present. One such (free) service is the automatic SMS text message that can be sent each and every time a credit card is used – a service that has been very successful in cutting the amount of credit card fraud.

One part of the banking sector that has yet to make much progress is the provision of residential mortgages. There is no doubt that this market will become very important in the future, not least because some 91 per cent of residential property is privately owned, and it is beginning to expand rapidly – albeit from a very small base. Development has been slow due to such factors as legislation that made it difficult for the lender to repossess the property when necessary and the lack of long-term loans. However, these barriers are being removed and the mortgage sector in Hungary is probably the best placed in the region to see meaningful growth in the near future. Government subsidies are available to encourage borrowers but the system is rather convoluted and has undergone a number of restructuring exercises in order to make it more attractive to both lenders and borrowers.

Demand for commercial mortgages is high, being driven primarily by foreign companies investing in factory and office accommodation for their own operations. The foreign banks are the largest providers of commercial mortgages, while the Hungarian bank, OTP, predominates in the provision of residential loans, although a number of other banks are now trying to increase their market share.

While most aspects of the banking market are fully catered for, there has recently been a rapid expansion in a number of niche areas. The market for home-collected credit in Hungary was created by a British company only very recently, but already this market has grown very rapidly and is expected to continue to do so for the foreseeable future. A similar pattern has also emerged in the provision of consumer credit provided in-store at the point of sale.

Financing trade and projects

Approximately 90 per cent of all trade in the European Union is conducted on an open account basis although many companies have some form of credit insurance. Trade with Hungary has not yet reached this level, but already some 75 per cent of trade is conducted on this basis, the proportion being even higher for lower-priced transactions.

Over the years, there have been many successful projects financed on a non-recourse project finance basis. These have been structured both with and without assistance from the British Export Credit Guarantee

Department (ECGD) and other export credit agencies. In recent times, ECGD has changed its policy on financing projects in the region in order to secure more business and this means that projects that were previously unable to obtain cover can now do so. Perhaps the most important change is that, in many cases, ECGD no longer needs a government guarantee but will accept municipality or large local corporate risk.

The trend towards financing major projects by way of partnerships established between central and/or local government and private companies has not been ignored in Hungary. Although the country had a bad experience with a motorway project some years ago, there is growing recognition of the impact that public private partnerships (PPPs) can have in developing infrastructure such as roads, rail, water treatment plants and many other large projects. This type of financing is being considered for a number of current projects.

Typically, laws need to change and attitudes and ideas need to become more flexible in order to make these projects happen. However, PPPs offer the most realistic way to finance the many projects required and as this becomes more widely understood the number of PPP projects in the country will increase dramatically. As Britain and British-based firms are world leaders in this type of finance, the development of the PPP sector in Hungary should be seen as offering many opportunities in the future.

Investment funds

Investment funds and providers of private equity have been active in Hungary for many years and the majority of such funds belong to the Hungarian Venture Capital Association. In very simple terms, the preferred scenario for a fund is to invest between US\$1 million and US\$5 million in a joint venture company with a local partner and a foreign strategic investor. Clearly this is an over-simplification and, for the right project, both smaller and much larger funds can be found and any commercially sound project can, in theory, attract funds.

A number of the locally based funds are effectively subsidiaries of the more global funds or are linked to banks. As the market continues to mature and stabilize, the growing demand for this type of funding is being met by the creation of new funds and the expansion of existing ones. The European Bank for Reconstruction and Development (EBRD) has recognized this and has recently co-invested in a number of new funds.

Insurance

Taken as a whole, the insurance market is very well developed, although life insurance is rather underdeveloped when compared with

the European Union. However, as sales of life insurance policies are now growing more rapidly than other forms of insurance, this sector will doubtless improve in time.

There are no state-owned insurance companies in Hungary. As with the banking sector, the early privatization and opening up of the insurance markets to foreign competition has ensured competition and the provision of a wide range of products. Again, as with the banking sector, the level of competition is already leading to a consolidation process.

Perhaps rather surprisingly, the development of private pensions in Hungary has exceeded most commentators' expectations and in many ways should act as a sound example to other countries in the region. As with every country moving towards a democratic market economy, there is an urgent need to move away from the provision of pure state systems and the Hungarian government has readily accepted this imperative. Implementation of the second and third pillars – the mandatory and voluntary contributions to a private pension fund – has been successful and very well taken up by the public. Rather perversely, however, the Hungarian government has been openly considering re-privatizing the pension funds and undoing all the good work that has been achieved. There would not seem to be any financial justification for this move but rather a misguided political motivation.

Legal

Part Two of this book is dedicated to legal issues, but given the impact of legislation on doing business in the financial services sector, a very brief outline is appropriate here.

Perhaps there has been more change in the legal sector, or more correctly the law, than in any other sector. Most of the big international law firms are present and many have been instrumental in adapting old legislation and writing new laws. As Hungary moves ever closer to a market-driven economy, the need for legislation to change to allow the economy to expand and foreign companies to invest and trade in a safe environment becomes ever greater.

The scope and depth of these changes has increased significantly as EU membership beckons. It is true that many of the laws are not yet directly comparable with UK or EU legislation, but much progress has been made.

Accountancy

One of the requirements for any company wishing to raise debt or equity funding, trade finance, or establish any form of partnership with a foreign party has been the need to produce accounts in line with

International Accounting Standards (IAS). All the large foreign accountancy firms are present and the trend towards international accounts continues to move down towards ever-smaller companies. Accountancy and audit issues are addressed in Chapter 3.3.

Stock Exchange

The Hungarian stock exchange is larger and generally more liquid than many other exchanges in the region and also has the highest market capitalization to GDP ratio in Central Europe. This is largely due to the transparent privatization process and the advanced economic restructuring that has already taken place and has attracted foreign portfolio investors. Foreigners hold approximately three-quarters of shares listed on the Exchange. There is a cooperation agreement in place with the London Stock Exchange and five Hungarian companies are listed in London.

However, none of this progress has prevented the decline of the Budapest Stock Exchange in recent times. Any domestic demand that there was has all but dried up and foreign investors have begun to focus on the top few companies. Until recently, the new monies going into private pension funds were helping, but the government talk of nationalizing these funds has cut off the flow of investments. Recently, criticism has been mounting at the high level of bureaucracy and an ever-growing number of companies are de-listing.

Corporate governance

The way in which business is conducted, the transparency of transactions and relationships, minority shareholder rights and general financial management are some of the main concerns behind corporate governance. As with many aspects of the financial services sector in Hungary, much has been done but more still remains to be done.

The overall level of corporate governance is, however, considered to be the best of any of the Central and Eastern European countries in transition.

Regulation

In April 2000, a new independent regulator was established in Hungary, PSzAF (or the Hungarian Financial Services Authority (HFSA)), which is essentially modelled on the Financial Services Authority in the United Kingdom. This body effectively combines the former Hungarian Bank and Capital Markets Supervisor, the State Insurance Supervisor and the State Pensions Fund Supervisor, and is thus responsible for supervising all sectors of financial services. The independent PsZAF is

funded by the Ministry of Finance and it has publicly stated that all aspects of its work will comply with EU regulations by the end of 2002.

Regulation and supervision of the various parts of the financial services sector is generally regarded as being relatively sound and continues to improve, although it is recognized that a lack of experienced professionals is a limiting factor.

Summary

The financial services sector has been totally transformed over the last 10 years. While mistakes have been made and there is still much to be done, the progress made has been remarkable and past mistakes are now being recognized and rectified.

In comparison with any other country in Central Europe, Hungary's financial services sector can be viewed as being strong, well developed and well regulated, as well as being very open and of considerable interest to foreign competition.