

# “Some characteristics of small and medium enterprises financing in Hungary”

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## Some characteristics of small and medium enterprises financing in Hungary

### Abstract

An overwhelming majority of Hungarian businesses are small and medium enterprises. They play a very important role in the economy. On the one hand, they provide more than two thirds of the economically active population with jobs, and on the other hand, they are responsible for 40 percent of total value added and for 20 percent of all exports. In stark contrast to their importance in the economy SMEs have to deal with severe financing shortages. Until very recently banks did not consider extending loans to small and medium enterprises an important strategic line of business. The study concerns itself with the financing of small and medium enterprises, their relationships with banks and aims to investigate possible development strategies based on various financing schemes. Businesses take out loans of different maturities to run their operations smoothly and to develop their activities, whereas such loans are secured by different sorts of collateral. Opening the market of mortgage loans for businesses would enhance the prospects of long-term financing for both debtors and creditors, thus facilitating faster growth on a more stable growth path.

**Keywords:** SMEs in Hungary, financing of SMEs, agricultural mortgage loans.

**JEL Classification:** E51, E64, G10, Q14.

### Introduction

From 1996 to the turn of the century Hungary's economy prospered. Economic growth was beyond 5 percent for a number of years, industrial production rose by double-digits and the balance of payments was in a good shape. Public finances were about to be balanced and both inflation and unemployment declined. Real wages rose and consumption expanded. The most important feature was that economic growth averaged at over 5 percent, keeping the balance of payments and the budget in equilibrium and putting the economy on track to meet the Maastricht criteria. This impressive economic performance came to be known as the "Hungarian model", dubbed so by the government. The optimistic view that Hungary's economy was on a stable and sustainable growth path became widely accepted.

The restructuring of the economy, which was based largely upon attracting foreign capital, neared its end towards the second half of the 1990s. As formerly state-owned assets were sold off more and more, FDI influx declined. At the beginning of the new century both the budget and the balance of payments started to show signs of deterioration in both nominal and GDP-percentage terms. The joint occurrence of such circumstances will in general result in a deterioration of economic competitiveness and conjure up images of social tensions.

In the year 2000 it became obvious that the main weakness of Hungary's economy is that its growth was basically being determined by external resources leading to ever increasing fiscal and monetary imbalances in nominal terms. In addition to that the uneven distribution of social burdens would lead

to social tensions. Although the development of the Maastricht based indicators and real flows were still widely deemed to be favorable, both the government and its critics realized that as a consequence of the adverse phenomena in the global economy and a domestic monetary policy hardly capable of acting as a strong defence, foreign direct investment, largely responsible for economic growth, could come to a halt. The straightforward consequence of that would be growing economic tensions and structural unemployment.

In Central Europe the 1990s were a period of economic transition. By the second half of that decade, as privatization and company reorganizations were by and large over the new private ownership structure began to take shape. In this region a very characteristic post-socialist ownership structure prevailed.

A major portion of the Gross Domestic Product was and still is being produced by multinational firms operating in duty-free zones. Small and medium enterprises, large in number though, did not play a major role in growth. Upon the fall of communism proprietors of small and medium enterprises were endowed with scarce resources only, while unevenly distributed and uncoordinated fiscal and tax policies in subsequent years did not contribute much in the way of promoting such businesses either.

It is very alarming that multinational firms, while their propensity to invest actively is in steady decline, do not have strong ties to domestic manufacturers and customers. In order to maintain their level of competitiveness and capital income multinationals started to shift their operations to areas outside Central Europe, to places such as Ukraine, Romania, China, etc. In doing so their considerations were centred around the question of specific wages in labor-intensive industries – favorable at the time of

setting up operations but no more – and the increasing saturation of local markets with the products they churn out.

The role of small and medium enterprises is vital in any economy. On the one hand, because they provide jobs to a great deal of the economically active population, on the other hand, because of their contribution to the Gross Domestic Product and to exports, and thirdly, because they are typically owned by domestic entrepreneurs.

Financial institutions tended to neglect advancing loans to this sector because of its relative riskiness. Due to high interest rates and high levels of inflation SMEs were forced to fund their operations by withholding profits. Under the current set of economic circumstances, however, banks are becoming increasingly interested in financing SMEs, since this is a relatively new market with high borrowing capacity. On the other hand, such businesses find themselves more and more in the borrowing position as they cannot fully fund their investments by retained earnings.

Our study concerns itself with the financing of small and medium enterprises, their relationships with banks and aims to investigate possible development strategies based on various financing schemes.

### 1. Small and medium enterprises in Hungary

An overwhelming majority (99 percent) of Hungarian businesses are small and medium enterprises<sup>1</sup>, while 66 percent of all enterprises are sole proprietorships. More than two thirds of the economically active population are employed by such enterprises. The SME-sector is responsible for 40 percent of total value added and for 20 percent of all exports.

In stark contrast to their importance in the economy SMEs have to deal with severe funding shortages. Until very recently banks did not consider extending loans to SMEs an important strategic line of business. In the past few years, however, the financing activities of banks directed at SMEs have multiplied.

Since 2000 one could observe a sudden shift of interest towards SMEs. Loans extended to such businesses rose by 500 percent between 1999 and 2006.

<sup>1</sup> In Hungary the concept of small and medium enterprises is defined by law (Act No. CXV of 1999 on Small and Medium Enterprises and the Promotion of their Development). Pursuant to the provisions of this Act the employment thresholds are identical with those set out in the relevant EU-regulations (the total number of employees not exceeding 250), while financial thresholds were set considerably lower. In Hungary a company is qualified as a small or medium enterprise if the volume of its annual sales does not exceed 4 billion Forints or its total assets (balance sheet total) do not exceed 2.7 billion Forints. In the EU the respective limits are 40 million Euros of annual sales or 27 million Euros of total assets (that is the upper limit is 2.4-fold of the Hungarian upper limit).

Table 1. Loans extended to micro-, small and medium enterprises (in billion Forints)

Type of enterprise	1999	2004		2005	
		Cumulative lending	Change from prior year (%)	Cumulative lending	Change from prior year (%)
Micro-enterprises	112.7	747.3	663.1	897.8	796.6
Small enterprises	110.6	456.5	412.8	929.7	840.6
Medium enterprises	237.7	1021.6	429.8	970.2	408.1
Total	461.0	2225.5	482.7	2797.7	606.9

Source: Péter Bilek, Tamás Borkó, Veronika Czako, Gábor Pellényi. SME financing between 2000-2005. International Center for Economic Growth, Európai Központ, 2006.

### 2. The prospects of SME financing in Hungary

The Hungarian financial system heavily relies on banks to provide funds to the economy, whereas in this respect the role of capital markets is negligible. Total market capitalization as a percentage of GDP amounts to less than 50 percent of the average of EMU countries, the financial systems of which also largely rely on banks. Especially the corporate bond market is underdeveloped.

We expect the banking sector to dominate the market for funding the corporate sector, mainly because of the limitations impeding the development of the domestic capital market. Since Hungarian firms are rather small, issuing and floating shares is an expensive option compared to taking out loans from banks. The indebtedness of the Hungarian corporate sector lags behind that of developed countries, although leverage increased sharply between 1995 and 1999 and is now close to the level in some European countries. Cross-country comparisons of lending by the banking sector as a percentage of GDP, however, show that the indebtedness of Hungarian businesses with loans is far below the average of Eurozone.

Table 2. Loans extended to Hungarian businesses by domestic banks as a percentage of GDP in 2005

Country, region	Bank loans as % of GDP
European Union	43
Hungary	26

Source: Péter Bilek, Tamás Borkó, Veronika Czako, Gábor Pellényi. SME financing between 2000-2005. International Center for Economic Growth, Európai Központ, 2006.

Once we take into account direct foreign borrowings, however, we arrive at a far higher level of indebtedness. In this instance the level of lending to Hungarian businesses already closes to the Euro-

pean average. We get a yet more precise impression if we account for the high level of foreign ownership in the corporate sector.

As we are entering a favorable phase of the economic cycle and Hungary's economy is starting to get in better shape we may expect further increases in the level of indebtedness of the corporate sector. Nevertheless there are some factors reducing the importance of foreign borrowing, such as higher exchange rate risk due to widened fluctuation margins and the cost of managing that risk, the gradual evolution of syndicated loan schemes servicing big borrowers and the declining cost associated with mandatory reserve requirements

On the other hand, there are forces counteracting these tendencies. A sharp decline of foreign borrowing is unlikely to happen as the subsidiaries of multinationals are inclined to borrow directly from their parent companies' foreign-based banks for reasons such as tax and earnings optimization, higher credit-lines or the parent company's strategy. We may rightly expect businesses focusing mainly on domestic markets to pursue different financing strategies than those relying heavily on exports, for a great deal of companies does not wish to manage increased exchange rate risk for the time being if that can be averted. Shareholders' loans are going to continue to play a vital role in providing funds to businesses due to the high presence and importance of multinational firms.

### **3. The business environment in which small and medium enterprises operate**

The role foreign direct investment has been playing in Hungary's economic development and in the transition process towards market economy can hardly be overestimated. It is largely due to the fact that Hungary's share in global trade has doubled in the past decade. Economic history shows that in the past fifty years there has been a close correlation between the speed of catching up and modernization of less developed countries and the frequency and magnitude of foreign capital inflow. It is verifiable that countries that were isolated from international capital flows have increasingly been at disadvantage and banished into marginal positions. Until the mid-1990s Hungary attracted the lion's share of foreign direct investment among post-socialist countries, as more than 50 percent of active capital investments were made in this country. By 2001 this cumulative value has declined to 25 percent. One has to bear in mind that the conditions to carry out foreign direct investment were the most favorable when mass privatization peaked. Neighboring countries started their respective privatizations attracting large amounts of capital investment only after the turn of the century, at a time when privatization in Hungary was by and large over.

Thus the competitive advantage stemming from the dynamics of foreign direct investment that Hungary enjoyed over its competitors until 1998 and – as far as its mid-term beneficial consequences are concerned – until the turn of the century has been vanishing from that time on. One case in point is the adverse development of foreign direct investment since 2002 compared to prior periods.

The change of government in 2002 meant yet another change in economic policy showing the unfortunate dependence of the economy on the political cycle, resulting in a somewhat “zigzagged” path. The “Széchenyi National Development Scheme” introduced by Prime Minister Viktor Orbán's government was gradually phased out and most of the calls under that scheme were declared closed. To replace that programme, in autumn 2002 the new government elaborated and submitted to Parliament its new “Smart Hungary” scheme aimed at spurring business investments. The goals of this scheme were to restore investor confidence, give a new impetus to investment, fasten the growth rate of investment spending and to attract new investors. To achieve this set of goals businesses had to be persuaded to plough back their earnings, that is to invest, and to make better use of Hungary's R&D and innovation capacities. The major goal of the scheme is to achieve faster growth in industrial investment spending and to contribute to the development of strategic services, making multinational firms set up their regional operations and headquarters in Hungary. Another priority is to help less developed areas with a high rate of unemployment to attract investments.

The scheme focuses on three priorities. On the one hand, the elaboration of a tax-incentive scheme in line with the relevant EU-regulations, targeted budget funding for some special areas of interest and making the procedures of authorities more business-friendly.

Both the continued efforts taken in the past fifteen years of economic transition to introduce sweeping reforms aimed at consolidating public finances and more recent measures taken in order to achieve compliance with the Maastricht and Copenhagen criteria are severely flawed, as is the Smart Hungary scheme, being based on such efforts and reforms. It is a fundamental problem that the fiscal and monetary environment in which both domestic and foreign businesses are operating holds a number of unknowns and uncertainties. Measures of the Central Bank aimed at fighting inflation will in the short-run deteriorate the international competitiveness of domestic companies in an environment of deepening fiscal problems. The budget deficit is soaring on end, which will sooner or later adversely affect the inflation rate. Both monetary and fiscal indicators were dismal in 2006, which fits in with recent years' worsening trends.

The projected budget deficit for 2006 was five hundred billion Forints, reaching one-and-a-half billion Forints at the end of the year. Using the Maastricht method of determining the budget deficit the latter amounted to 9.6 percent instead of the 3 percent prescribed by the Maastricht criteria. As far as the social insurance funds are concerned the “customary” deficit of forty billion Forints which planners, though conscious of the fact it would eventually be exceeded, have been taking as a basis in prior year was replaced by a projected deficit of 250 billion Forints.

#### 4. Agricultural mortgage loans in Hungary

One of the main characteristics of economic activity is the continuous use of credit. Businesses take out loans of different maturities to run their operations smoothly and to develop their activities, whereas such loans are secured by different sorts of collateral. In many instances the debt capital employed in businesses far exceeds equity.

Increasing the role of agricultural mortgage loans would surely alleviate the financing problems encountered by the Hungarian agricultural sector. Opening the market of mortgage loans for agricultural businesses would enhance the prospects of long-term financing for both debtors and creditors, thus facilitating faster growth on a more stable growth path.

As the case is, the maximum amount lent is determined, on the one hand, by the fair market value of agricultural land pledged as collateral and, on the other hand, by the borrowing requirements of the agricultural sector. On the financial institutions’ side, however, the amount lent is going to be determined by the solvency of the agricultural sector as a whole and by the demand for mortgage debentures. Thus mortgage lending in agriculture hinges on the conditions prevailing in the market for agricultural land, in the profitability of the agricultural sector and on financial markets.

This sort of lending would enable financial institutions to extend high volume loans, which at the same time are low risk. The fair market value of one hectare of agricultural land would typically be between 100,000 and 800,000 Forints, which is a considerable amount of money, even if we bear in mind that the price of agricultural land is rather depressed. Taking an average price of 200,000 Forints/hectare the fair market value of the 4.3 million hectares of agricultural land – based on which the EU-funding of the sector was determined – adds up to 860 billion Forints<sup>1</sup>.

Again, on the financial institutions’ side this sort of

<sup>1</sup> The total area of land in agricultural use is 6.1 million hectares, of which: 4.7 million hectares are arable land, 0.1 million hectares are gardens, 0.1 million hectares are orchards and 1.1 hectares are lawn. Taking the area of 6.1 million hectares as a possible collateral, the total loans that could be extended would be as high as 1,202 billion Forints.

lending is associated with lower risk than average market risk, since land, as a factor of production, is not subject to depreciation. With careful and proper cultivation and farming its value can even be increased.

The prudential regulation of the operations of financial institutions specialized in extending mortgage loans encompasses legislation on:

- ◆ the capital adequacy requirements towards such financial institutions;
- ◆ limitations applying to their investments;
- ◆ collateral; and
- ◆ continuous control<sup>2</sup>.

Legislation on capital adequacy requirements applies, on the one hand, to the minimum amount of authorized share capital necessary to set up a financial institution as well as to obtain the operating license, and, on the other hand, to the desired levels of the solvency ratio and capital adequacy ratio while carrying out operations.

Act No. XXX of 1997 on Mortgage Banks and Mortgage Debentures stipulates that the authorized share capital of mortgage banks must be at least 3 billion Forints, to be paid in cash in full<sup>3</sup>.

The other element of capital adequacy regulations that banks must observe are the provisions on the capital adequacy ratio.

This ratio gauges solvency and is closely related to the risks of lending, since in its denominator we have the bank’s assets less accruals and impairment losses adjusted for risk. Thus the amount in the denominator is the bank’s total lending net of the accruals/provisions (impairment losses) created at the expense of the interest spread, that is, the amount net of the expected credit (repayment) risk<sup>4</sup>. The sum in the numerator is the respective mortgage bank’s liable equity capital. Pursuant to the provisions of the Banking Act the ratio thus calculated shall be at least 8 percent. This requirement brings to bear the legislators’ intentions on the issue, holding that a bank’s operations are deemed

<sup>2</sup> Act No. XXX of 1997 on “Mortgage Banks and Mortgage Debentures”.

<sup>3</sup> Act CXII of 1996 stipulates that the minimum authorized share capital of banks must be 2 billion Forints, with an additional 1 billion Forints in case of specialized financial institutions. The authorized share capital of savings co-operatives must be at least 100 million Forints.

<sup>4</sup> There are two types of credit risk:

- ◆ The expected risk characteristic of distinguished groups of borrowers observed in prior periods. Banks have to create so called risk-provisions/accruals, whereas the cost associated with creating such reserves has to be covered by revenues from the risk premium. As a consequence of new accounting rules the creation of risk accruals/provisions was replaced by impairment losses as of January 1, 2001.
- ◆ Idiosyncratic or non-systematic risks are such resulting from shocks or recessions affecting markets, regions or economies as a whole. In such instances the risk premium does not provide any protection. In order to fend off losses due to such occurrences banks have to meet certain capital requirement criteria.

to be safe from the point of view of its solvency, if after creating the provisions/accruals to cover expected losses it still disposes of equity capital equivalent to 8 percent of its total lending net of such provisions.

Section 23 of Act No. XXX of 1997 on Mortgage Banks and Mortgage Debentures stipulates that the Financial Supervisory Authority may order the respective mortgage bank to transfer its mortgage loan portfolio and additional collateral if its capital adequacy ratio falls below four percent for a period exceeding ninety days and if it cannot restore the adequate level within the time interval prescribed by the Authority.

The Act on Mortgage Banks and Mortgage Debentures contains provisions as to the maximum amount lent as well. Pursuant to the regulations contained therein the amount of the loan extended must not exceed seventy percent of the fair market value of the collateral. Mortgage banks must at all times dispose of such amount equivalent to the outstanding face value and interest of mortgage debentures in circulation.

Procedures applying to the determination of the value of the collateral are prescribed by law. Upon determining this value banks base their considerations on a so-called "emergency sales price", a price they can obtain with a high probability under any set of circumstances. In the end the sum borrowed will be around half the fair market price of the real property encumbered by mortgage.

Act No. XXX of 1997 puts a strong restriction on mortgage banks' ability to acquire land: it prescribes that such banks may acquire real property (except for property necessary for that bank's operations) in order to avert losses from providing financial services only by way of bankruptcy or liquidation proceedings. Once acquired, such land must be sold by public auction within three years. A further limitation is that a mortgage bank's cumulative share in companies thus acquired may not exceed ten percent of its liable equity capital<sup>1</sup> and that the sum of its investments in real property may not exceed five percent of its liable equity capital<sup>2</sup>.

The regulation of mortgage bank operations and mortgage debentures by law puts such banks in a

position to operate safely in the long run and ensures an adequate level of solvency. Mortgage loans are a type of loan providing financial institutions with profits at below-average risk levels.

Agricultural businesses have been able to take advantage of such loans since 1989 when the Mortgage Credit and Lien Bank was first set up. From 2003 onwards commercial banks have started extending mortgage loans. This was made possible by the fact that the National Land Trust assumed the obligation<sup>3</sup> to take over the land of debtors defaulting on their loans<sup>4</sup>.

At present businesses do not take a keen interest in taking out mortgage loans. The sum of all mortgage loans extended by the Mortgage Credit and Lien Bank has not exceeded 1 billion Forints to date. Nor is the new type of mortgage loan introduced in 2003 very appealing. For one thing, high interest rates are to blame. Interest rates as high as 14-15 percent, though pushed down to 8-9 percent in the case of subsidized soft loans, are way too high for agricultural businesses operating on low returns and profitability. On the other hand, in case of the agricultural sector the titles of actual ownership and legal use of land are separated, causing confusion on the market for agricultural land. Then there is the fact that leases are usually not long-term, making it difficult for mortgage loans based on leasehold relationships to establish themselves as a solid form of financing. An accord between lessor and lessee would be needed to apply for a mortgage loan. In Hungary 56.9 percent of agricultural land is used as leaseholds, whereas in the case of arable land this ratio is as high as 68.8 percent. Thirdly, the sheer size of so-called micro-estates does not allow the proprietors to take out loans. The average size of land cultivated by individual farmers is 4.5 hectares. 45.1 percent of all agricultural land is being cultivated by such farmers. This group of proprietors is not credit-worthy<sup>5</sup>.

<sup>1</sup> The total net lending of the financial institution may not exceed 100 percent of its liable equity capital. Act CXII of 1996 on Financial Institutions and Financial Enterprises, Section 85.

<sup>2</sup> The same applies to financial institutions. Section 84 of the Act quoted above.

<sup>3</sup> Banks, being companies, are not allowed to own land. Under the current set of economic circumstances land auctions are associated with considerable uncertainty.

<sup>4</sup> On the condition that the market value of the estate was established by a real-estate valuer approved by the National Land Trust and that the market value of the estate has not changed considerably in the meantime.

<sup>5</sup> The portion of those farming on farmland of over 50 hectares is less than one percent of individual farmers.

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