# Development of Banking Industry in Hungary

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*Abstract:* In the last two decades banks faced new challenges. The paper analyses the convergence of financial intermediaries in terms of business area development and service innovation, focused on banking companies. The concept of bancassurance is not clearly defined neither in theory nor in practice. Banking industry development can also be determined from a functional and an institutional point of view. Functionally means the range of financial services and includes the banking and insurance services. The institutional approach is based on the organisational cooperation between banks and non-bank institutions.
Based on Hungarian national data, we find that the penetration process, so the entry into insurance services – primary targeted life insurance services - industry is mostly driven by banks in Hungary.

*Key-words*: banking industry, service innovation, mergers, transition, bancassurance

## 1 Introduction

Due to the financial deregulation of the late 1970's, the number of competitors of banks increased dramatically. Disintermediation means, among others, that commercial banks lost a lot of important positions against investment banks, investment and counter-investment funds. These newly occurred financial institutions have gained increasing market share and as a result the deposit-taking and credit outsourcing role of banks was gradually shrinking.

Hungarian banking system had few years delay in the development process. In 1987 a new two-tier banking system was introduced in Hungary. Beside the Hungarian National Bank five commercial banks were created in the process of reform: Hungarian Credit Bank, Budapest Credit and Development Bank ltd., Hungarian Foreign Trade Bank, General Banking and Trust Company, National Commercial and Credit Bank. All these banks were Hungarian owned companies, regulated by The Act on Financial Institutions. This Act defines banking activities, the types of banks, rules for establishment of banks, capital adequacy and liquidity requirements and the creation of reserves. In ten years, until 1997, Hungary's bank privatisation policy led to the rapid process, resulted four of Hungary's five large state-owned banks sold to foreign owners.

The privatisation, than the consolidation of banking system and the wave of deregulation and liberalization in the last two decade created the basis for new mergers in the financial system.

This paper is dealing with the convergence process to introduce the detailed analysis of integration of financial intermediaries, called bancassurance. Due to the radical changes in the function and structure of financial markets and to the regulation reforms, the services provided by the financial institutions became reasonably different. In the last decade the most conspicuous change in the financial sector is the increasing convergence of banks and insurance companies. Nowadays many banks offer insurance while insurance company products compete with bank savings. This tendency is bordered by various concepts – bancassurance, allfinance, assurfinance, financial conglomerates.

As a consequence of the product range widens, the services becoming more complex, the regulation is liberalized and the merger wave of corporations, financial suppliers also became more complex and their activity structure became more diversified.

## 2 Problem Formulation

Kotler (1998) gives a very simple definition to service: "service is such every act or output which can be offered by one party to another and which is essentially not materialised and does not result in ownership. The production of the service is either attached to a material product or not."

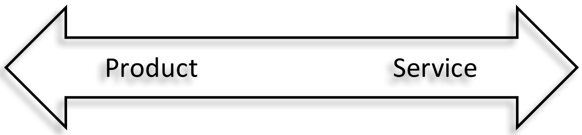
Services have 4 main characteristics:

1) *Incomprehensibility*: contrary to the material products the services are not materialised, the customers cannot try it before purchasing.
2) *Inseparability*: The formation of services is coinciding with the consumption. It is adverse with the process typical for material products and it often means that the customer influences the result of the preparation of the service.
3) *Heterogeneous*: services are unique depending on where, when and from whom customers resort it.
4) *Perishable*: services can not be kept in storage so the fluctuation of demand can not be compensated and the not capitalised service capacity is gone.

Services and products have their own distinctive characteristics but nowadays we can hear more often the expression banking and/or insurance product (Figure 1.). There is a base for it because there are factors which show oncoming between the characteristics of products and services. The development opportunities for new "products" are ever better in the filed of services because of the integration. Relations maintaining, and the degree of labour- and capital-intensiveness also changed. The "product" became the new mode of existence among services (so the services became products).

The comparison of products and services can be divided into 3 different parts. The distinctive characteristics ensures the basic and permanent elements, differences. The second group cannot be separated that easily by the characterisation of products and services because of the obvious convergence. New tendencies such as globalisation, integration, disintermediation and deregulation give the basis for new dimensions.

Figure 1: Comparison of products and services




| | | |
|---|---|---|
| **Distinctive characteristics** | • Physically displayed, durable goods<br>• Output can be stockpiled<br>• Quality can be easily measured<br>• Long reaction time<br>• Can be tested | • Intangible, perishable goods<br>• Output cannot be stockpiled<br>• Quality cannot be easily measured<br>• Short reaction time<br>• Cannot be tested (based on trust) |
| **Approxi-mation factors** | • Poor communication with clients<br>• Wide range of options<br>• Capital-intensive | • Strong communication with clients<br>• Low potential<br>• Labour-intensive |
| | • Regional, national and international markets<br>• Heterogenity | |
| **New dimensions** | • New quality dimensions<br>• Mass customisation | • Personalisation<br>• Co-development with clients |

*Source: Own model, using Krajevsky-Ritzman (1996)*

The aim of financial suppliers is to make individuals to invest their money in them. However the persuasion means an intense competition in the procurement of the savings and accordingly in the encouragement of demand.

The demand for financial services has gone through fundamental changes during the last couple of years which can be ascribed to 3 main factors.

1. The developed western states have gone through fundamental demographical change. The ratio of the aged population increased which lead new claims to financial suppliers.

2. The second reason is the restructuring of savings because of the changes in economic circumstances.
3. The third factor is the fast development of the awareness and the information of customers. This forced commercial banks and other financial suppliers to provide more competitive, more demanding and more complex services than before.

In recent decades, affecting all industries have become the elements of globalization, deregulation and liberalization trend. As a result, strategic groups, corporate giants have emerged, which became the focus for the operation of the increased risk reducing diversification. The strategic management literature has traditionally relies on four main strategies of diversification, as Ansoff (1957) outlined: horizontal, vertical, concentric and conglomerate diversification strategies.

Horizontal integration can be defined as ownership or increased control over competitors' (David 1989). In most cases, this strategy is characterized by the merger or acquisition of the competitor. This position is concentrated as the existing products, markets, or both increases the level of corporate activities is included. In case of large firms, this strategy has limitations that may violate the Competition Act. The horizontal growth strategies can be defined as a strategy, by which is not related and/or unrelated products are sold to existing customers. David (1989) differentiates a horizontal integration, which includes the acquisition of a competitor, and one that the introduction of new products and services means. This second category does not include the acquisition or establishment of new units, but fully integrated into the existing company structure. Consequently banking and financial M&As are horizontal.

Vertical integration is defined as the company's business scale expansion, incorporating the activities of suppliers and customers. There are two types of vertical diversification. The first is a backward integration, which entails the acquisition or ownership of the company increased control over supply. The other type, the forward integration, means the control over distributors and resellers. This may involve the purchase of a distribution system, or to set up such a system internally. The main disadvantage of vertical integration is that the supplier is bounded to a single business, even though there may be cheaper producers in the market as well. Finally, by changing needs, in vertically integrated units may occur coordination difficulties (Hill-Jones, 1989). Despite of all this, the cost savings, cost avoidance in the market, quality control and applied technology can be the potential benefits of the strategy. The convergence in energy sector – which has the second largest M&A volume after financial sector – is vertical character integration. (Read more about the parallel of M&A in financial and energy sector in Deutsch (2011) and Deutsch-Pinter-Pinter (2011)).

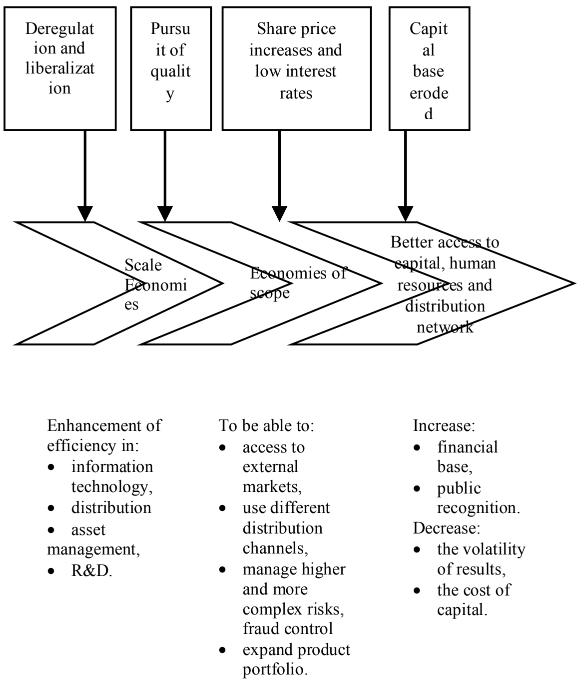
The concentric diversification means that we give something new, but related product to the company's existing product line (David, 1989). The new product's technology and marketing aspects are in synergic position with the company's current products. It can be seen that this group has many similarities to the horizontal integration (new but related products are not introduced), as well as vertical integration – regarding the inputs as new related products.

The conglomerate diversification strategies include a category for which there are no obvious technological or marketing synergies, or cross-selling opportunities. This strategy of the 1960s became well known, and is still often arise in the literature (Porter, 1985). Hill and Jones (1989), however, argued that unrelated diversification can bring greater benefit than the related, as the latter increases the organizing difficulties. The diversification strategy is a tool for mergers and acquisitions initiative. Figure 2 shows the driving forces of the application of mergers and acquisitions.

The main driving forces - economies of scale, access to economic resources and efforts – can be completed by the following factors, which in theirselves are not turning up the merger-acquisition activity, however, help to create a favorable environment:

- market deregulation and liberalization
- move the customers' preferences for large service providers (search for quality)
- increase in stock prices and low interest rates
- eroded capital base.

Figure 2: Forces of M&As in the banking sector




Source: DIBC (2003)

When company executives announced a new merger or acquisition is their intention, the most commonly cited reason is that the newly created business unit, economies of scale provided by the realization of cost synergies will be able to. The reason is that the larger units can be more efficient for smaller ones. This is due to the fact that many of the cost of operation do not increase proportionally with the size of the company. Obvious examples are the brand and support structure, a highly specialized product development, information technology system to establish and maintain the distribution network and asset management. Typically, larger companies seem easier to attract adequate employee, equity capital and external funding. The larger companies re-configure more easily their business portfolio, ceasing product lines and activities that are making losses and are not part of the group's strategic thinking. In addition to economies of scale lead to the consolidation of the organizational profile of economy development as well. This may result from the fact that the combined business units are also able to continue to become a party goes beyond the individual profile. If the mergers and acquisitions are successful, - the efficiency increases - then the product or service mix improving, and have better access to customers, and all the shareholder value and return on equity increases (Welborn, 2004). (More about valuation of financial institutions in Takács (2009)). Furthermore, when a group diversifies the risks of diversified business lines, it usually reduces the volatility of profits, and thus the capital cost. In addition, if the groups are showing an intensive financial strength, this means they take a lot of advantage. They will be able to share capital, and obtaining other external sources for lower cost, to carry out easier investments and divestments.

Arising equity markets and low interest rates generate favorably environment for mergers and acquisitions. The recovery of stock markets blow up the capital base of undervalued companies is particularly favorable target for the expanding groups. Mergers and acquisitions integrate the know-how in one organization, but it can also cause major problems of integration. Any alternative costs occurring in acquisition, it should be compared with the costs that are occurring in the case of new entry. In many cases, new entry provides more flexibility in planning new services.

## 3 Problem Solution

There are only a few references in the literature, which is about the roots of evolving convergence of bancassurance in Hungary in the early 20th century. In Europe, bancassurance holds one third of the total market share and many of its market – such as France, Spain and Italy – have reached maturity, but Hungary not. Whilst Hungary was the first financial market in Europe that developed and introduced integrated financial and insurance services, during the First and Second World War lost the institutional and capital basis of the financial system. The supply of complex financial and private insurance services that can be met by bancassurance ventures, still have minimal growth rate because of the legal background.

It is important to understand this factors behind the lower degree of insurance and banking culture after the 1920s. The fairly liberal yet communist Hungary had established in 1949 the State Insurance Company (Állami Biztosító, ÁB), which had acted as the sole insurance provider for domestic and international affairs. From the 1950's the insurance and banking system and institutions operated strictly separated. As part of the Transition reforms in 1986, the Government enacted legislation that partially liberalized the insurance industry by ending ÁB monopoly in the country. During the same decade Hungary's bank privatisation policy led to the rapid process, resulted four of Hungary's five large state-owned banks sold to foreign owners. Consequently Hungary's financial and insurance market set to growth significantly. Hungary was the first among the transition countries to develop a strong and independent financial system. The institutions and markets in transition had to fulfil some roles adequately (Bonin-Wachtel, 2003):

- Facilitate the mobilization of savings
- Allocate financing to investment projects
- Price risk and assets
- Monitor corporate performance
- Assist the transfer of ownership

The institutional development was not the first priority in the financial system. Through the privatisation the foreign participation ensured effective and strong banking system, but the regulatory structure and the supervisory system was not sufficient for the later, higher level of competition in the sector.

Under central planning the financial system is not too much more than a bookkeeping mechanism for recording decisions about resource allocation between sectors and enterprises. At the beginning of the transition process the following reforms were implemented (Reininger et al, 2001):

- two-tier banking system with separate functions for central banks and commercial banks,
- sectoral restrictions on specialised banks were lifted,
- privately owned banks were admitted,
- foreign banks and joint-ventures were granted access,
- the licensing policy for most of banking business was liberalised,
- the legal framework and supervisory system were adjusted.

By 1998 Hungary became the first country in the European region which established a privately owned banking sector and successfully overcame the burden of bad debts, undercapitalization and high concentration (Hasan-Marton, 2000). Hungarian banks are now mostly profitable despite the high capital standard and are close to meet the requirements set by the European Union in terms of regulatory and supervisory aspects. Despite the growing role banks in transitional economies, economists paid less attention to the strategies adopted by the financial institutions.

### 3.1 Financial convergence factors

The convergence of banks and insurance companies varies country by country because of the social reforms, the supervisory influence and other factors. The continuous changes of the institutional, economic and demographic conditions, the intensifying competition, or the entrance of non-business line related competitors could indicate the saturation of the markets. The emergence of new markets is due to the growth of prosperity, the innovation and technological development of services.

Banks need to broaden their activity to be competitive, but success depends on several factors, on aligning the people, organisational, cultural and financial assets.

Table 1: Factors give rise to financial convergence

| Factors | Consequences, effects |
|---|---|
| 1. Operating Synergy | |
| • Economies of scale | enhanced value, access human capital, capabilities, skills, enter new region |
| • Economies of scope | profile, expand product/service offering |
| 2. Financial Synergy | cost efficiency |

| | |
|---|---|
| 3. Diversification and market, product/service development | stabilizing returns New products/services – New markets, Current products/services – New markets, New products/services – Current markets |
| 4. Increased market power | anti-competitive effects, fraud control |
| 5. Customer focus | distribution channel optimization ("under one roof"), better access to customers, segments |

Source: own source based on Pintér (2007), DePamphilis (2011), Pilloff-Santomero (2007)

The banks and insurance companies try to cost-effectively transform their existing markets and/or try to explore new markets. To do this, different strategies are available. One of these alternatives is the convergence of banks and insurance companies. The success of this depends on whether the providers of services (comprising different business lines) could manage organically uniting the different corporate and product philosophies. They must offer a total benefit, which is greater than to satisfy their financial needs with a separate bank and insurance company.

Basically there are two options to provide addition benefit to the customers. One possibility is that with the help of convergence they must realise a cost reduction in service training and in sales. Because of the pressure of the competition it is not necessary to count with the targeted cost savings would be used to rise the interest spread. A part of the cost savings reaches the clients in favourable conditions. The other possibility is to provide a surplus to the clients, to get to know precisely their financial needs and satisfy the financial needs as much as possible. Bancassurance service providers are offering those kind of integrated banking and insurance products, which are offered from one hand or independent service providers via one network, or if it is necessary only banking or insurance service can be sourced. So bancassurance doesn't mean the full linkage of the non-banking and insurance business, but a limited selection-deepening and expansion as well.

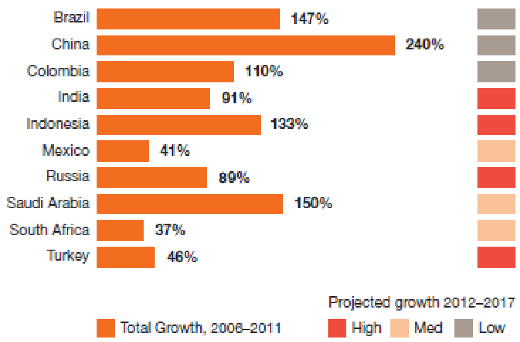
In a narrower and more practice-oriented sense we understand bancassurance as the approach of banks and insurance companies, which focuses on the better use of infrastructure and sales network.

The expressions of Allfinanz, bankinsurance, assurfinance and Financial Services are also used to determine bancassurance. Our earlier determination was built on the extensive definition of Allfinanz. Bancassurance means the type of bank effort when the banks enter the insurance business with an own-established entity or with a cooperation to offer a comprehensive range of products from one hand. So usually they link traditional banking products and insurance services – life, accident and property insurance – and than sell those via the banking network. In contrast assurfinance describes a similar way startegy of the insurance companies. The bancassurance, assurfinance and Allfinanz usually appear in practice as supply-oriented strategy, which they try better using the currently existing market conditions. The US originated Financial Services concept is based on the idea of advising as per lifecycle. The financial needs of the individual, i.e. security, savings, financing, and need for care changes during of their life. These claims must be fulfilled effectively and efficiently as possible, using the help of integrated supply.

The clients and advisers are looking for those kind of opportunities that are covering as a combination of the investing, financing and insurance needs.

Insurance companies are searching the way for sustainable distribution strategies. The non-life insurance market is rapidly diversifying influenced by emerging markets. From 2006 to 2011, total premiums worldwide rose 27 percent, with the majority of that growth driven by emerging markets. The "E7" emerging markets – China, India, Brazil, Russia, Mexico, Turkey, and Indonesia – registered a 140 percent increase in property and casualty (P&C) gross premiums, whereas in G7 countries (US, Japan, Germany, UK, France, Italy, and Canada) grew by approximately 10 percent over the same time period. (PwC, 2013)

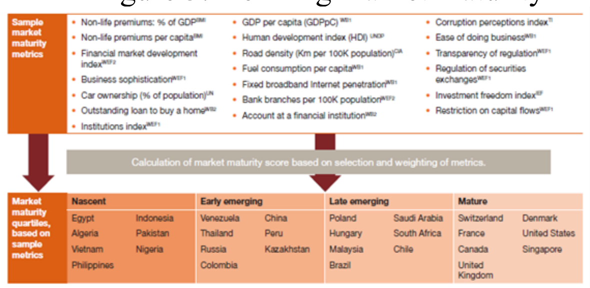
Figure 2: Recent and projected P&C premium growth in selected emerging markets (2006-2017)




Source: PwC, 2013

We need to analyse the market maturity to evaluate the sector strategies. But there is no single definition for market maturity. Insurance companies should devise market maturity scores according to their product focus and growth strategies.

Figure 3: Defining market maturity




Source: PwC, 2013

The maturity of insurance and banking markets can be estimated by aggregating into a single score metrics.

### 3.2 Problem Solution

In Hungary only 11 out of the 41 banks provide life and non-life insurance activity, either through their own insurance company, or within a contractual cooperation. Considering the performance of the banks, most of them have a ROE under 15%; the Return on Assets significantly falls between 0-3%. It is also important that 70,6% of the banks have less than 30 branches and only three banks have more than 150 branches. From this data we may predict the differences between the banking strategies and the pressure on the profitability. I have prepared the sector analysis with the application of multiple variable statistics, factor and cluster analysis. For the full survey of the banking sector I used the data of the PSZÁF (HFSA – Hungarian Financial Supervisory Authority) between the period 2005-2011 and performed the analysis with the help of SPSS statistical analysing programme.

### 5.1. Research findings

In the practical research among the Hungarian banks and based on the knowledge of the regulatory environment it is also proved, that in Hungary only a few (althogether three) banks perform real bancassurance activity, with the own establishment of financial type service subsidiaries. In terms of the integration of the banks' and insurance companies' cooperation in Hungary from the cross-ownership, deeper integration form to the loosest form of distributional cooperation examples can be found. Beside the category "bancassurers", 10 banks formed an other cluster named "universal or universal type of banks", they do not have an own established subsidiary, but they are in a cooperative agreement with other service providers. The previously mentioned two clusters are in my opinion, the representative of the Hungarian bancassurance activity.

From banking side basically the increasing saving function of the life insurance, the consumer need to expand the product range and the poor utilization of the branch networks gave the main reason for the development of the Hungarian bancassurance market. In turn the insurance companies saw the opportunity in the new cost-effective distribution channel provided by the bank branches. Of course in terms of the development of the bancassurance those factors must be mentioned as the aging of the population, the distrust towards the state-funded pension system, and the imported bancassurance experience of the banks and insurance companies with foreign parent company, or the rapid development of the banking infrastructure. However, the low level of customer loyalty, the initially low level of financial culture, the bankers' lack of insurance know-how and somewhat the regulation are all against the strengthening of the bancassurance as well.

## 6. Conclusion

The liberalised-deregulated financial regulation system allowed banks and insurance companies to cross the formerly strictly designated borders. Mergers and acquisitions are one of the main banks responses to higher competitive pressures in banking industry. Banking industry development – turning into bancassurance process – in Hungary has detectable signals, but the extent of the barriers is also significant. All bancassurance models can be found in Hungary, but mostly driven by banks. The partnership and cross selling function is very strong between banking and life-insurance products, so bancassurance strategy and service innovation is focused on life insurance life cycle.

Hungary is an emerging bancassurance market in non-life business, and a developing bancassurance market in life insurance related business. There are no specific consumer protection rules, the aggressive marketing policy by banks during the financial crisis and the poor financial knowledge of households effects negatively on the developing process (Csiszárik-Kocsir et al., 2008; Gonulal et al, 2012).

The synergy potential is significantly bigger in the case of life insurance, than in the area of non-life insurances, because the economies of distribution is significantly more important in life insurance.

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