The Construction of Credit Card Markets in Hungary, Poland and the Czech Republic

Akos Rona-Tas

University of California, San Diego

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Introduction

In much of the developed and developing world the 1990s saw a large increase in consumer credit. In OECD countries, just in the last half decade of the last millennium household debt as a ratio of household income rose from 78% to 96% (Christensen and Mathiasen 2002, Babeau and Sbanu 2003). In post-communist transition countries consumer credit is still a novelty but its pace of growth is even more impressive (Cottarelli at al 2003). Between 1997 and 2001, consumer lending in Poland, Hungary and the Czech Republic grew by 26% annually (Economist 02/27/2003) while other countries in the region with a lower starting point have produced even more striking rates of growth. Mortgages, purchase credit, credit cards, auto loans are advertised in all cities and an increasing number of people apply for them, to buy now and pay later. Today, banking professionals in East and Central Europe fret over excessive consumer debt and economists pen alarmist treatises on the potential macro-economic disasters resulting from too much consumer borrowing.

To understand how this dramatic change happened in Central Europe, we will focus on a special segment of the consumer credit market: credit cards. At the intersection of bankcards and consumer credit, credit cards are still few but their numbers are growing rapidly.

How did a credit card market emerge in Poland, Hungary and the Czech Republic? The principal thesis of this paper is that markets do not emerge naturally but are constructed in a complex, social and political process. Here we will concentrate on some of the institutional conditions, the role of foreign ownership, market structure and two forms of cooperation among banks: the creation of common system of card processing and information sharing about borrowers' credit behavior. Our central claim is that institutional conditions developed in

response to various crises of the post-communist transition while the initial structure of the market, inherited from the communist past had a strong path dependent effect on bank cooperation (Rona-Tas 1998).

Macro-economic conditions

The market for consumer credit and credit cards in particular, require a set of macro-economic conditions, the first of which is low inflation. For credit cards, just as for any other forms of consumer credit, low inflation is a necessary but not sufficient condition. In Figure 1 and 2, data from a wide range of countries show that until inflation is tamed and pushed under 20 percent, credit cards will not proliferate.[1] In recent years, inflation dropped in Central and Eastern Europe (Figure 3.). Yet, a low inflation rate by no means guarantees the take off of a credit card market, not just because lower interest rates made possible by lower inflation are not necessarily passed onto consumers. There are a host of other conditions that must be present.

Another macro-economic factor is the overall development of a country (Figure 4.). Not surprisingly, there is a strong correlation between purchasing power and credit card use.[2] East Central Europe has turned the corner of the post-communist recession by the end of the 1990s and have been on a steady growth path ever since (Figure 5.). What matters here is not just that people have more and more to spend but that the steady growth creates positive expectations about future earnings and one's ability to repay loans. Indeed, consumer borrowing grew in the region. Much of it was led by mortgage lending as housing markets began to emerge and housing prices started to grow.

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[1] Turkey is an outlier but not by much.

[2] In this group of countries the Cayman Islands are an exception and has a much higher credit card penetration than it should based on its level of development. Once we remove this outlier from the data, the R-squared jumps to .53.

Institutional conditions

Since 1990, the financial markets throughout Central Europe have gone through profound transformations. In all these countries, under socialism retail banking was the monopoly of the state savings bank. In Poland, PKO, in Hungary OTP and in the Czech Republic (Czechoslovakia) Sporitelna was the retail giant where people deposited their money and borrowed funds from. For the citizens of socialist Hungary, the word OTP was a synonym for "retail bank." Even though in Poland and Hungary, there were also savings cooperatives serving mostly rural areas, there role was marginal. In Poland, there was also a separate bank PEKAO licensed to handle foreign currency transactions of residents. Before 1989, there existed purchase credit for more expensive consumer durables and housing but consumer lending was sparse. Moreover, since the ultimate employer for most people was the state (Poland was different in this respect, as it had a sizable private peasant sector), in most cases the risk of lending was minimal. The bank could simply recover missed payments from the employer of the borrower.

A two-tier banking system began in Hungary in 1987, in Poland in 1989 and in the Czech Republic in 1990. It separated the Central Bank and the commercial banks, leaving the former in charge of the currency. In the early 1990s, a series of laws liberalized entry, interest rates and product markets and each country enacted a series of laws to regulate banking. Laws on deposit insurance were introduced to increase confidence in the banking system. Bank supervision was established and reporting and international accounting standards were put in place. In all three countries, banks had to weather major crises. Hungary and Poland went through a crisis period between 1992 and 1995 as the restructuring of socialist industries left banks with defaulting loans. In Hungary, this resulted in three bailouts and an acceleration of bank privatization to

foreign buyers. The last and biggest bailout was tied to various measures one of which was the creation of a debt reporting system for corporate credit.

In Poland, there was one major bailout, but this was tied to strict requirements of restructuring. Privatization took a slower path there than in Hungary. In the Czech Republic, bad debts from the communist era were consolidated in a single bank. The other banks were partially put through voucher privatization but in the major banks the state retained majority ownership. It was not until 1996-1997 that the Czech banking system fell into a crisis. This then created pressures for fundamental changes and to sell the big banks to foreign investors. It took another few years and a spectacular failure[3] for the Czech government to complete bank privatization.

Today, in all three countries the vast majority of the banking sector is in foreign hands, mostly owned by European and US financial institutions. [4]

For the first part of the 1990s, the banking sector in all three countries was preoccupied with corporate lending and, especially in the early years, investing in government bonds. Retail banking took a back seat. In the late 1990s, enterprise lending became more competitive. Companies began to turn to foreign lenders, especially if they had foreign ownership or business partners. Some of the large multinationals brought their own banks to these countries. These foreign banks opened small subsidiaries to service a handful of foreign clients. Thus local banks had to look for new areas of expansion. At the retail market, local banks had a natural advantage as consumers were unable and unwilling to bank across borders. If a foreign financial institution wanted to lend to individual customers in the region it had to set up shop there. As economic growth began to pick up the retail market also became more lucrative.

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[3] Nomura purchased controlling share in the Investment and Post Bank in 1998, stripped it of its assets and by 2000 it brought it to the brink of bankruptcy threatening the entire banking system.

[4] Notable exception is the Hungarian giant, OTP and the largest Polish bank PKO SA.

Foreign ownership

Foreign ownership of banks brought not just new capital to the banking industry but also new management, culture and technology. Starting in the early 1990s, banks revamped their entire internal IT system, moving from paper to electronic data processing. This was the most difficult for the large savings banks with their enormous number of client records scattered in millions of filing cabinets in their branch offices spread all over the country. New foreign owners brought in their own IT systems, often wreaking havoc with or scrapping entirely the technology put into place a short time earlier.

The importation of new technology followed two, sometimes contradictory logics. Multinational banks brought new ways of banking to serve better local customers and make operations more efficient. At the same time, the local bank, now a part of an international group, had to consider issues of internal compatibility and consistency and adjust its methods to those prevailing in the rest of the group.

There are two areas in the organizational structure that new owners without exception considered strategically crucial: marketing and risk management. When a bank became privatized the new owners immediately took over these two areas promoting their trusted managers into leading positions. In the Czech Republic, in 2005 nine of the ten top banks had risk managers brought in from abroad by the new foreign owner. In the three countries, we found not a single bank that would outsource either risk management or marketing to outside contractors.

Foreign owners sought to reproduce the menu of financial services they offered in their home country. In many instances, products were introduced simply because they existed elsewhere. Some foreign banks, specializing in multinational companies felt that they had to

provide for their client's every financial needs to keep them, even if some of those services were not profitable. Thus new retail products appeared on the market often through mimicry and bundling.

Market Structure

In all three countries the retail market began with a single communist savings bank. These banks had the vast majority of the residential accounts offering them a large amount of information that newcomers did not have. Their clientele was also captive by sheer inertia. People were used to the state savings bank and trusted it because of its size and the belief that the state stood behind the bank. Size also meant convenience. The large network of branches made access easier than clients would find with small upstarts. In all three countries, early bank reform aimed at eliminating this monopoly but this turned out to be more difficult than expected. The initial conditions would have effects well into the 21st century. Not even multinational bank groups with deep pockets could increase their market share quickly and overcome the initial advantages of the savings giants easily.

In the Czech Republic, after the initial reforms, Ceska Sporitelna along with the newly created Komercni, IPB and CSOB formed the big four of Czech banking. In Poland, next to PKO, the foreign currency specialist bank PEKAO had a branch structure by 1989, as it had to serve the large number of Polish guest workers and immigrants sending money to their families back to Poland. PKO therefore from the very beginning had a junior rival that already had a retail clientele. In Hungary, OTP initially had little competition. The newly created banks were all much smaller and an effort to build a new retail bank around the wide network of post offices did not result in a strong enough bank to challenge OTP. Between 1995 and 1999, industry

concentration measured as the total assets held by the top three banks was 72 percent in the Czech Republic, 57 percent in Poland and 53 percent in Hungary. Yet, in some way, this is misleading. In Hungary, OTP was by far the largest and the second and third (K&H and MKB) followed at a distance. In the Czech Republic, the top three banks (CSOB, Sporitelna and Komercni) were closer in size; hence the three had a larger share of the total. This is reflected by the more recent figures (Table 1.).

The concentration looks slightly different if we look at retail banking. In Poland, PKO has 35% share of the retail market, followed by PEKAO with 18% and BZ WBK with 9% is a distant third. In Hungary, OTP has 38% of household loans and 44% of all deposits followed by K&H with 10% and 14%. For the Czech Republic, we could not find similar numbers, but the top three are in the lead there as well. The concentration of the retail market impedes not just competition but also, as we will argue, cooperation.

Bank card market

One segment of retail banking is the services linked to bank cards. Bank cards are payment instruments and range from ATM and debit cards to charge and credit cards. In the three countries, debit cards are by far the most common cards. At the start, bankcard markets are faced with a "chicken-or-egg" problem. For people to want a card there must be enough merchants who are willing to take it. But for merchants to want to sign up to take cards, there must be enough people who hold cards. This problem was solved by the state paying its employees through a bank account and giving a card to access the account. In Hungary, for instance, the state put out a tender for employee accounts to banks, won by OTP and Budapest Bank. This instantly created the critical mass of cardholders.

Yet a large number of cards will not create a well-functioning card market if the cards use different processing systems and cards in one system are incompatible with the POS (position of sale) or ATM machines of another. At the beginning, banks can either choose to cooperate and create a common infrastructure or can decide to compete and hope that their processing system will win and then can force other banks to use their system (and pay them the processing fees). In Hungary, OTP tried the second tack and for a while, merchants had to keep multiple machines to process card payments. Currently, the largest card processor serving more than one bank is Giro Bankcard Ltd., which is operated by the second largest bank, K&H. OTP and many of the larger banks are not members. They either have their own system or use the infrastructure set up by the multinational card companies VISA or MasterCard. In 2005, there were 7.5 million bankcards in Hungary, and of those almost 900,000 were credit cards.

In the Czech Republic, in 1992, Komercni, IPB and CSOB with some other smaller banks initiated the creation of a Bank Card Association, which entrusted the company MUZO to develop a common bankcard infrastructure. Not surprisingly, Sporitelna initially was reluctant to join but later it did. Last year, there were 7 million bankcards in the Czech Republic but less than 450,000 are credit cards.

In Poland, banks and the Bank Association and some banks created PolCard the largest card processor in the country. The two largest banks, PKO and PEKAO, however, have their own processing system called Centre of Cards and Cheques. There were over 15 million cards in Poland in 2003 and only 7% were credit card then. During the next two years, the number of credit cards tripled.

The creation of a common processing system is difficult in a market where the size of the players is uneven. Large banks have less incentive to cooperate than small ones and giants will

try to force their own solutions onto the rest of the market. The most cooperation is found in the Czech Republic, because on that market there is no single mammoth. The least cooperation can be found in Hungary, where OTP is large enough to strike out on its own weakening the motivation for cooperation for the others.

Card issuers also must cooperate to fight card fraud. Each country has its fraud forum. In Hungary this meets every three months, elsewhere with less regularity. At the forum card professionals rarely discuss their own bad experiences in detail. Rather they talk about general issues of fraud prevention. These forums are often facilitated by the international card companies (VISA, MasterCard, American Express etc.).

Sharing Credit Information

Credit card markets require cooperation from banks not just because they are special card markets and need standardization but also, because the credit card is a low or no-collateral credit product. Banks, therefore, must screen applicants and thus lenders require information that only other lenders can supply. Credit bureaus, public and private, that administer information sharing among lenders about borrowers and thus reduce problems of information asymmetry, are key pillars of modern credit markets. There are two types of credit reporting. Negative reporting systems, or black lists contain only bad information about borrowers. It includes only those who were late or defaulted on their loan payments. Full-reporting systems register all transactions, both good and bad ones.

Creating any system of information sharing means that lenders must give up their own information for which they often paid dearly, to get information from others. In concentrated markets, large and small banks are in very different situations. The larger a bank is in relative

terms, the more information it must give up compared to what it would gain from the exchange. Small banks, on the other hand, are always very interested in information sharing as they would gain more than what they must give up.

It is easier to share negative information, because it punishes bad clients and it is a relatively inexpensive way to sanction and deter bad behavior. Yet large banks release more bad customers than small ones do (assuming all banks have the same default rate). Discharged bad customers, if there is no information sharing, will likely to go to other banks and repeat their bad behavior. Big banks may decide that it is worth more to harm competitors than to punish bad borrowers.

As black lists contain information about a person only if that individual did something bad, not being on the list means that one is good. There is no difference between a good and a new borrower. If there is a working black list, bad borrowers will try to change their identities so that they can appear as good by being new. They will apply under someone else's name.[5] Moreover, black lists do not show the whole picture. Knowing about good transactions too, puts bad behavior into context and allows lenders to see the relative frequency (and thus calculate probabilities) of default and they may also discern what direction the tendency of the client's behavior is pointing. Full reporting also allows banks to easily see the client's full debt load. In a full reporting system, people accumulate their reputation over time and assuming a new identity means one must start all over. The main problem with full reporting is that by disclosing good clients, banks open their clientele to poaching by others. Or to put it differently, with their history public, good customers can take advantage of competition for their business. When only a black list exists, only bad reputation is portable. Good reputation is not. Being good carries no advantage for the customer because only his own bank knows about it, but it carries advantage

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[5] In corporate lending, companies on the black list would go out of business and reappear as different legal entities.

for the bank because lending to good customers is more profitable as good customers pay the same price as anyone else.

In Hungary, only black list type reporting exists for individual customers. The reporting system (BAR) was created in 1995 and was part of a massive bailout package in a moment when the banks were in no position to protest or ignore the directives they received from a nervous state administration. How little importance consumer lending carried in those days is expressed by the fact that the system was designed almost entirely with corporate lending in mind. The system did establish a registry for consumers, but while for companies, there is full reporting, for consumers there is only a black list. Hungarian bank professionals claim that the consumer list is incomplete and that the largest player, OTP, reports "irregularly." The largest bank itself has a low opinion of the list. Indeed, data quality is a concern. Using names as identifiers, the list can easily mistake people with common names for others. Moreover, the system was originally written to use the English alphabet ignoring Hungarian diacritics creating even greater confusion. Many lenders elect not to use it when they make offers to customers with whom they already had satisfactory experience of some sort. In certain situations, such as issuing purchase credit on the spot through a retailer, lenders must weigh time constraints against information that is of dubious quality. The Hungarian Banking Association has been eager to create a full-reporting credit bureau. In its efforts, it is hampered not just by the OTP but also by data privacy considerations. Hungary's ombudsman for data protection has been strongly against a full reporting system without explicit consent from customers. Banks that otherwise would support such a system balk at the idea of requesting a waiver from the client because they think this will scare customers away and will send them to those banks that do not require such a waiver.

In Poland, a full reporting credit bureau started in 2001. It is owned by some banks and the Polish Banking Association. Over half of the banks are members, including PKO and many other larger banks. The second largest, PEKAO, however, had resisted the creation of BIK and was not supplying data as late as mid 2004 citing data processing problems. Initially, the biggest contributors received a discount on each inquiry but this ended soon. The data being gathered by BIK is quite extensive as the Polish law passed in 1997 and allowing for data sharing among banks did not stipulate its content. It includes not just the usual credit information but also socio-demographic data, such as income, education, profession and employment history although banks can choose not to provide this information. Each time a new transaction is entered, these socio-demographic variables are updated. Store related credit providers and most cooperative banks tend to opt out of the system. The former do, because they find the 1 Euro charge per inquiry too expensive. Cooperatives, on the other hand, operating in villages and small towns feel they know their customers well enough not to need BIK's report. There are various problems with the records here as well. Some, like in Hungary, has to do with diacritics and various ways to abbreviate names. Others are related to mistakes committed by other bureaucracies, such as the Interior Ministry that occasionally assigns erroneous ID numbers to individuals. [6]

In the Czech Republic, the Czech National Bank initiated the creation of a credit bureau and in 1998 a law was passed that made possible information sharing among banks without the clients' consent. This, however, led to various legal challenges on the grounds of privacy rights to personal data. Even though the law on Personal Data Protection of 2000 did not challenge the law on credit reporting by allowing earlier laws to stand, the Data Protection Office raised objections. Now, individuals must sign a statement that waives their right to the secrecy of their credit information. Seven banks founded the bureau, CCB, in 2002, the four big banks among

[6] IDs are not arbitrary but carry certain information about the person.

them. The effort was led by GE Capital, a new upstart and CSOB. Sporitelna was strongly against a full-reporting system because being the biggest, it had the most to lose. The main turn occurred when in 2000, Erste Bank of Austria bought Sporitelna and the new owners, who had used information from full-reporting credit bureaus routinely in other markets reversed the bank's position. Their experience in Austria convinced them that having both good and bad information was valuable in risk management. Because of the early legal challenge, the scope of data collection is narrower in the Czech system and does not include socio-demographic information such as profession, position or type of activity for the self-employed. Some banks are still reluctant to join. Zivnostenska with a large elite clientele had been unenthusiastic fearing that the credit bureau would enable other banks to cherry pick its lucrative customer base. When Zivnostenska was taken over by UniCredito Italiano, the new owners made the strategic decision to expand their retail lending and move from elite, relational, personalized services to a mass market. Subsequently, Zivnostenska joined the credit bureau. Other banks are waiting to see how privacy concerns will be worked out in the legal system and sit on the sidelines for the time being.

Poland and the Czech Republic are the only two countries in the region that operate a working full-reporting credit bureau. Hungary's case is more typical for the region.

Credit Card Markets

Credit card markets are at the intersection of bankcard and consumer credit markets. American style credit cards are still few in Central Europe but their numbers are growing quickly (Figures 6,7,8). Banks often start to market credit cards to their own most trusted clients. This strategy has two advantages. First, banks have sufficient information on potential card holders. Second, they have savings or checking accounts that they can hold as collateral in case of trouble. Other banks start with the top and mid-level employees of their corporate clients. Here the company mediates the risk of credit card lending. Yet more and more banks realize that the only way to achieve a critical volume in the credit card business is by offering cards to new customers applying “from the street.”

The credit card market in all three countries is dominated by VISA and MasterCard, most banks offer both brands. There are also domestic brands and there are credit cards that are useable only in a restricted circle of vendors. While in the United States the bankcard market began with credit cards and only now do debit cards become popular, in the three countries debit cards came first and only recently have credit cards begun to take off.

Favorable macro-economic changes have been undoubtedly important in laying the foundations for the spread of credit cards in Central Europe. Yet for credit cards to grow, a market had to be constructed. This involved the creation of a stable banking system, finding real, in most cases by necessity foreign, owners and various forms of cooperation among banks which are in fierce competition on the market. Although slowly eroding, the initial concentration of the retail market still makes its presence felt after a decade and a half.

Figure 1.

Credit Cards per Capita and

Inflation Rates in 2000 for 62 Selected Countries

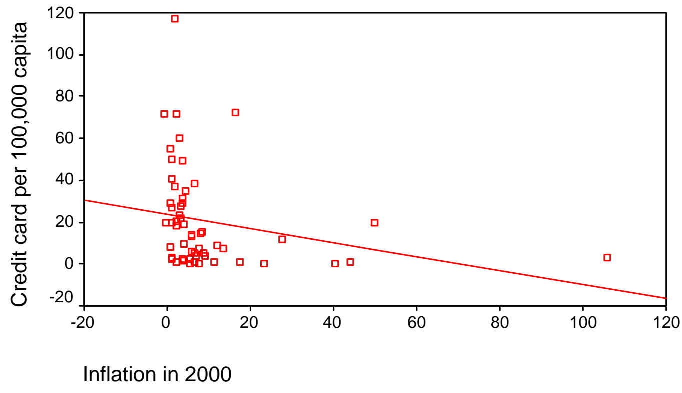


Figure 2. Credit Card Transaction Volume

per Capita and Inflation Rates for 54 Countries 2000

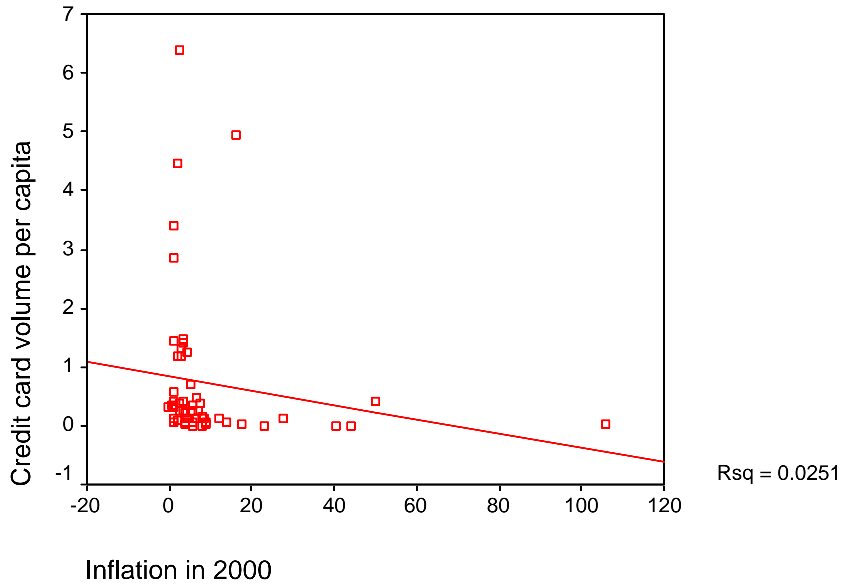
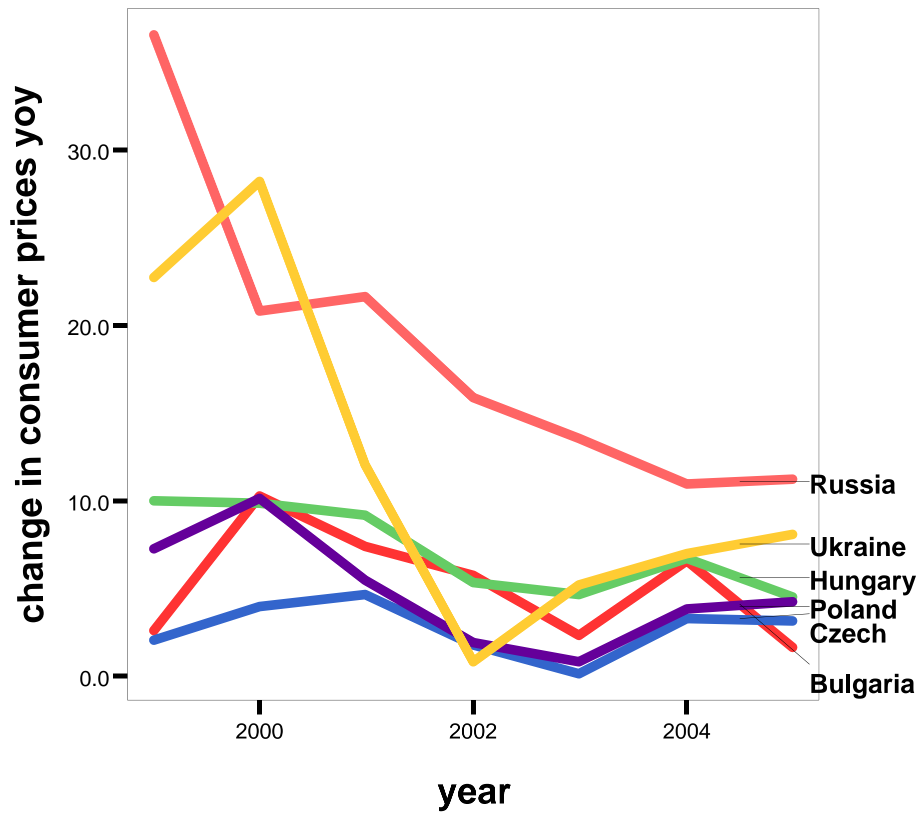


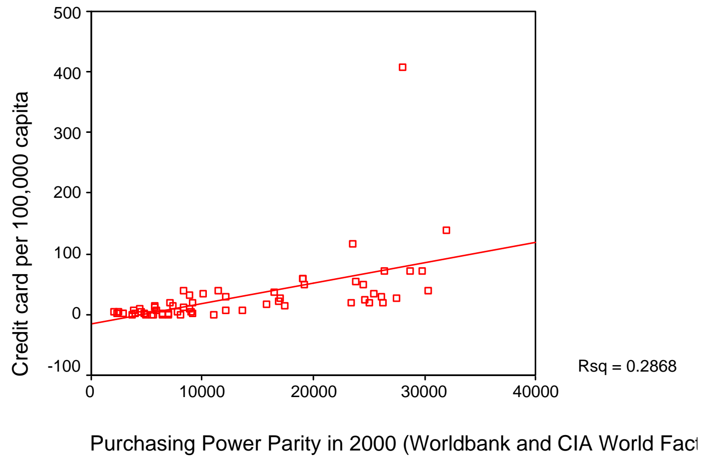
Figure 3.
Change in Consumer Prices in Selected Central and East European Countries



Source: CEE Banking Sector Report RZB Group

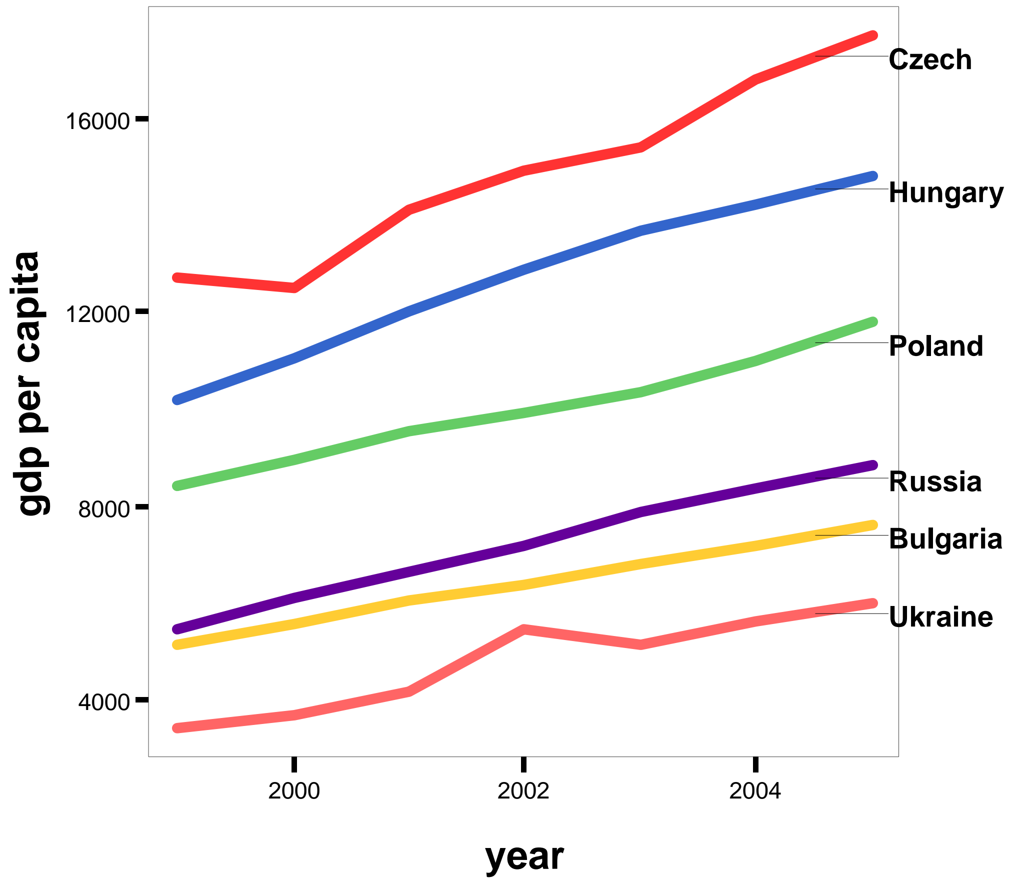
Figure 4. Purchasing Power Parity in 2000

and Credit Card per Capita for 60 Countries



Source: Nilson Report, World Bank and CIA World Fact

Figure 5
GDP per Capita Growth in Central and Eastern Europe



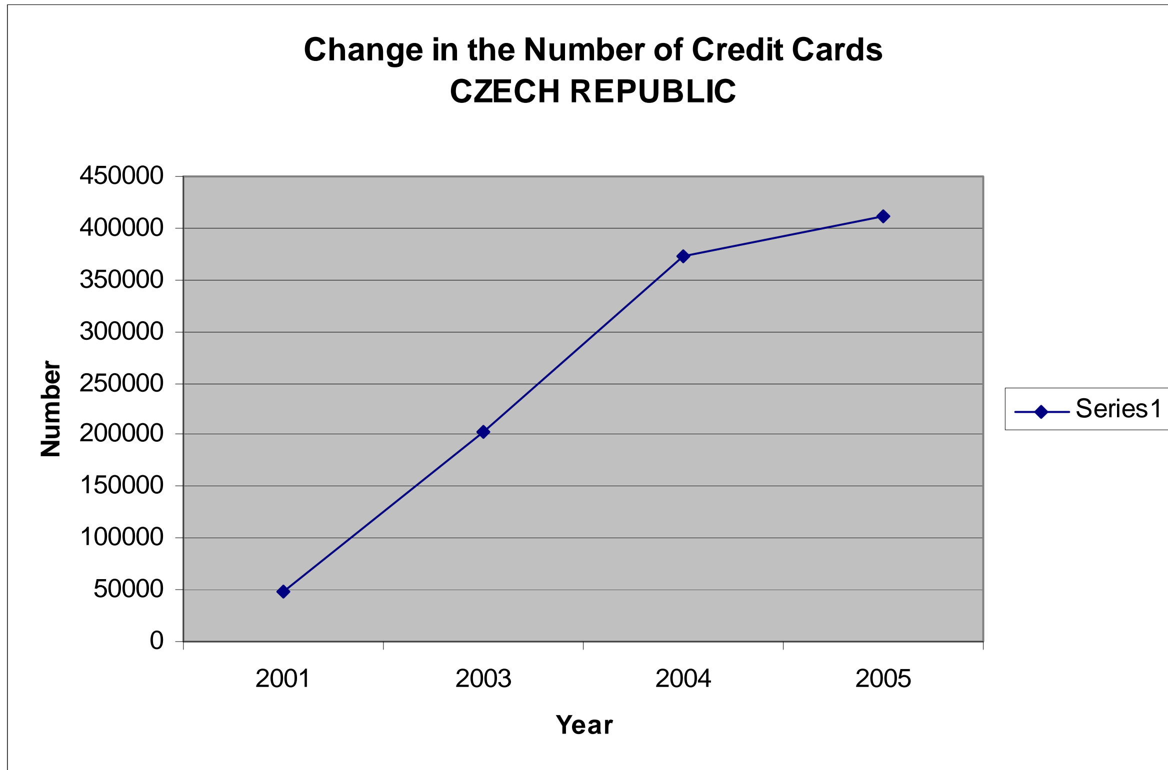
Source: CEE Banking Sector Report RZB Group

Table 1.
Market Structure in Hungary, Czech Republic and Poland
Top Six Banks Measured as the Percent of Total Bank Assets Held

	Percent of the total assets
HUNGARY	
OTP	**18.3**
K&H	**9.4**
MKB	**7.6**
CIB	**6.9**
Erste	**5.9**
Raiffeisen	**5.4**
Total number of banks	**36**
CZECH REPUBLIC	
CSOB	**20.1**
Cesky Sporitelna	**18.2**
Komercni Banka	**17.5**
HVB	**5.1**
Commerzbank	**3.6**
Citibank	**2.7**
Total number of banks	**27**
POLAND	
PKO	**16.4**
PEKAO	**12.0**
PBK	**8.9**
Bank Handlowy (Citibank)	**6.3**
ING	**5.6**
BRE	**5.2**
Total number of banks	**60**

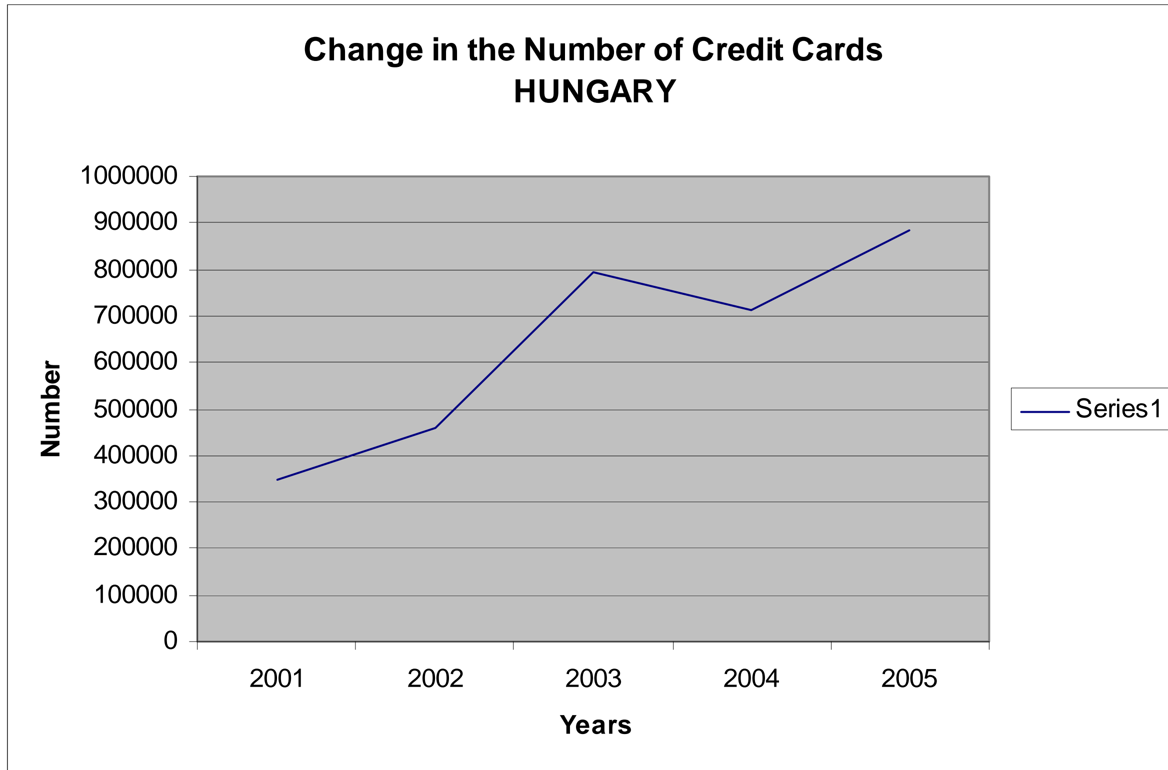
Source: CEE Banking Sector Report RZB Group

Figure 6.



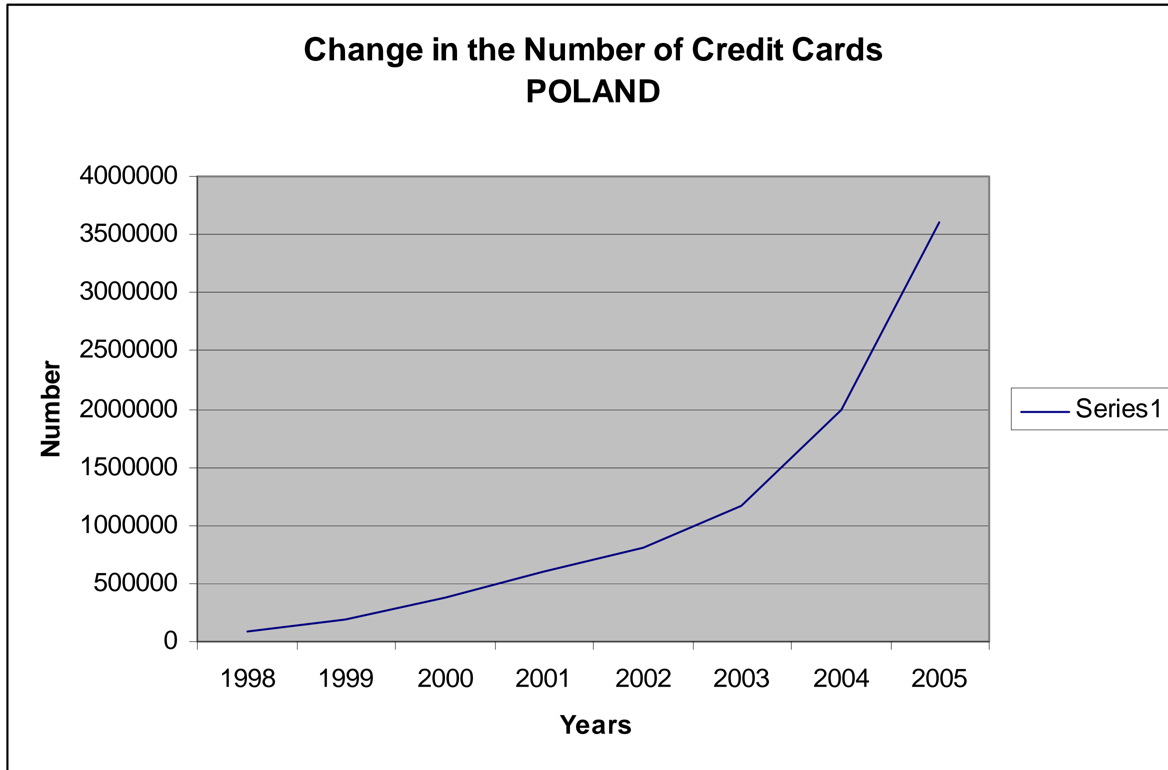
Source: SBK

Figure 7.



Source: Hungarian National Bank Note: From 2004 only credit cards with grace period are included

Figure 8.



Source: Polish National Bank

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