

HUNGARY INTEGRATED SUPERVISION OF FINANCIAL CONGLOMERATES

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On April 1, 2000, an integrated governmental authority commenced its supervisory activities in the financial services sector pursuant to Section 12 of Act CXXIV of 1999 on Supervision of Financial Institutions. This article attempts to provide a brief overview of the integration process of the decentralised supervisory authorities in Hungary.

Multiple authorities and integration

At the beginning of the transition to a market economy (late 1980s), functionally separate institutions supervised the traditional areas which comprise the capital markets, i.e. securities, banking, insurance, etc. Until 1996, four different authorities controlled the capital markets, irrespective of the growing overlap among the various segments of the markets:

- the State Securities Supervision (which operated as the State Securities and Exchange Commission from 1994),
- the State Bank Supervision,
- the Supervision of the Voluntary Mutual Insurance Treasuries, and
- the State Insurance Supervision.

These so-called decentralized authorities made the supervision of single market participants effective, however, they could not, for example, address the structural problems of financial conglomerates nor effectively handle a financial crisis. Moreover, the transparency of the network of separate authorities decreased as the number of the institutions grew.

The first relating to the integration was implemented in 1997 when the State Securities and Exchange Commission and the State Bank Supervision merged to create the State Capital Market Supervision, which monitored the establishment and the operation of investment companies, banks and financial undertakings.

The second wave of the integration attempts to unify all the remaining supervisory authorities thus, the Financial Institutions Supervision now encompasses all of the former institutions which existed in the respective areas of supervision, and thus shall exercise their competences.

Integration and consolidated supervision

From an investment protection standpoint, such integrated supervision has been a long-awaited response by the applicable state bodies in the faces of challenges of rapidly developing financial services market. The underlying incentive for integrating the authorities was that financial instruments and resources, i.e. securities, savings accounts and insurance investments, have become interchangeable to a large extent as compared to previous decades. Consequently, the providers of such services have entered each other's market, which has evolved into a merger-wave between the various financial entities and strong oppositions from government bodies. Objections were raised the possibility of allowing investment banks and savings banks to merge, since it was argued that this may lead to the obscurity of the capital adequacy ratios required of

financial institutions and thus weaken investor protection.

In spite of the strict restrictions on acquiring stakes in credit institutions as per Section 37 to 44 of Act CXII of 1997 on Credit Institutions and Financial Undertakings (“Credit Institutions Act”), the concentration of the Hungarian capital market and recent EU-legislation required the implementation of *consolidated supervision* methods. Accordingly, Sections 90 to 96 of the Credit Institutions Act established the consolidated supervision of *banking groups*, the capital adequacy of which shall be calculated by adding the capital reserves, or the portion of the capital that corresponds to the stake or voting rights held in that company, assets of the bank, its controlled financial institutions and any affiliated undertakings. Should capital adequacy calculated on a consolidated basis (clearly indicating the capital adequacy for each entity), it may prevent the so-called “*double gearing*”, when the same financial instrument would be a reserve asset covering multiple risks.

Consolidated supervision is better suited for controlling the credit risks and large exposures risk naturally attributed to the banking sector. However, such concept cannot be put into practice unless a proper institutional system is established. It is the integrated supervisory system through which such consolidated supervision may be implemented, and thus, the structural problems of financial groups may also be more effectively monitored.

Other considerations of the integration

While consolidated supervision is an essential element of the stability of the financial market, other factors should also be given due consideration. One of these factors is the issue of the authority’s division within the integrated authority. Another practical issue is whether the state budget would be able to support the increased costs of such an integrated authority. In addition, another issue relates to whether consolidated supervision should also not endanger the equal treatment of or unduly burden those entities subjected to the Act. However, as consolidated supervision applies to non-financial companies as well, if they are controlled for example by a bank, this may hinder their position on the non-financial markets to the advantage of “independent” competitors, are not owned by banks.

Finally, it is also important to note that the integration of governmental prudential control does not affect the strategic control over the banking system which is exercised by the central bank. The consolidated supervision of financial groups should not be the extension of the “safety net” maintained exclusively for savings banks, as this would serve as a type of “insurance” for non-bank members of the group, which would more likely induce them to enter into transactions with an excessive amount of risk.

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