

## OVERVIEW ON BANKING REGULATIONS

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### I. TWO-TIER SYSTEM

The Hungarian banking system is based on the two-tier structure in which the central bank, known as the National Bank of Hungary, represents the first tier and the other financial institutions belong to the second tier.

#### 1.1 The first tier: the National Bank of Hungary

The duties and the competence of the National Bank of Hungary are set forth in Act LX of 1991. The National Bank of Hungary is the bank of issue in Hungary and is responsible, among other, for:

- the preservation of the external and internal purchasing power of the national currency,
- the accumulation of stocks of gold and foreign currency,
- the control the supply and the demand for money and credit,
- participation in refinance transactions,
- maintain the accounts of the state, central organizations, financial institutions and other institutions engaged in the providing of financial services, however, those not belonging to the category of financial institutions.

#### 1.2 The second tier: the universal banking system

Securities, savings accounts and insurance investments, i.e., the three main types of financial services, have become interchangeable to a large extent as compared to previous decades and the banks have continuously attempted to provide a greater number of services to their clients better and to extend their market share by offering a wide variety of financial services. Consequently, banks, brokerage houses and investment companies have entered each other's market, which resulted in a merger-wave between these various financial entities. However, governments raised strong opposition, since it was argued that this may lead to dubious financial transactions and thus weaken investor protection. The merger-wave between banks, brokerage houses and insurance companies resulted in the implementation of consolidated supervision structures by governments. Therefore, the gradual transformation of the isolated financial services into a universal banking system became possible in the Hungarian financial market. With respect to credit institutions, banks may enter into all the three main financial services areas set forth below.

##### *1.2.1 Financial and ancillary financial activities*

The activities of the other financial institutions are regulated in Act CXII of 1996 on Credit Institutions and Financial Enterprises ("Banking Act"). Only those activities set forth in the Banking Act qualify as financial activities and only financial institutions may perform

such activities. According to the Banking Act, the performance (on a commercial basis) of the following activities qualifies as financial activities:

- a) collection of deposits and acceptance of other repayable monetary instruments from the public in excess of the equity capital;
- b) lending;
- c) financial leasing;
- d) financial transaction services;
- e) issuing of cash-substitute payment instruments, also including related services;
- f) providing surety bonds and bank guarantees, as well as other banker's obligations;
- g) commercial activities in foreign currency, foreign exchange (not including currency exchange activities), bills and checks on own account or as commission agents;
- h) intermediation of financial services (agency activities);
- i) custodian services for investment funds;
- j) account management services, safety deposit box services;
- k) credit reporting services;
- l) asset management services rendered for voluntary mutual insurance funds and private pension funds;
- m) cash transfers.

In addition to the financial activities described above, the financial institutions may perform only the following ancillary financial services:

- a) currency exchange activities;
- b) the operation of transfer systems for clearing operations (clearing operations transactions);
- c) money processing activities;
- d) financial brokering on the interbank market.

The above activities set forth by the Banking Act are harmonised with Annex I on the list of activities subject to mutual recognition of Directive No. 89/646/EEC of the European Union ("Second Banking Directive").

### *1.2.2 Investment and complementary investment services*

Furthermore, the banks are allowed to perform the entire scope of the following investment (from paragraph a) to e)) and complementary investment services (from paragraph f) to m)) as set forth in Act CXI of 1996 on the Offering of Securities, Investment Services and on the Stock Exchange ("Securities Act"):

- a) agency activities,
- b) consignee's activities,
- c) commercial activities,
- d) portfolio management,
- e) underwriting guarantees,
- f) securities custody and the services related thereto,
- g) securities safekeeping,
- h) rendering consultation services concerning the capital structure, and rendering of consultation and services concerning the merger and demerger of enterprises, as well as transformation of ownership structure,

- i) organization of the offering of securities and/or takeover of a company limited by shares, and the services related thereto,
- j) investment counselling,
- k) providing of development loans,
- l) keeping of securities accounts,
- m) keeping of client's accounts.

### *1.2.3 Insurance services*

The Banking Act provides that banks may also perform insurance agency activities in accordance with the provisions of Act XCVI of 1995 on Insurance Companies and Insurance Activities ("Insurance Act").

Finally, the Banking Act sets forth further limitations relating to the activities that may be carried out by banks. However, allowing banks to enter into the securities and the insurance market does not mean that banks may extend their activities to other non-financial services, with the exceptions of the following:

- a) auxiliary financial activities;
- b) commercial transactions in gold;
- c) keeping registers of shareholders; and
- d) liquidity and risk management services as described in the Securities Act.

On the other hand, the Banking Act prevents market participants other than financial institutions from providing financial services, with the exception of the intermediation of financial services (agency activities).

### *1.2.4 The types of financial institutions*

The Banking Act provides for two main categories of financial institutions in the framework of which financial activities may be carried out:

- I. credit institutions, and
- II. financial enterprises.

With respect to the first category, there are three types of credit institutions:

- 1. banks,
- 2. specialised credit institutions, and
- 3. co-operative credit institutions.

Distinction is made among the above credit institutions on the basis of whether they may accept deposits from the public at large or only from a certain group of clients. In any event, only credit institutions may obtain permission to collect cash and other repayable money investments from the public in amounts exceeding their equity capital.

## **II. REGULATION ON BANKS AS CREDIT INSTITUTIONS**

### **2.1 The shares of the bank and their registration**

The Banking Act requires that all shares of the bank be registered shares and the boards of directors of banks are obliged to keep a register of shares indicating the data as follows:

- a) name and personal details of shareholders;
- b) securities code number, series, serial number and the face value of the shares;
- c) type of shares;
- d) date of the share purchase;
- e) date of registration of the share purchase;
- f) date of impressed stamping;
- g) date of cancellation and destruction of the shares, and
- h) case number and date of the resolution of the Financial Institutions Supervision ("FIS") related to the acquisition of ownership.

The register of shares is required to be maintained in such a manner that both the current and the changed data can be confirmed subsequently.

### **2.2 Minimum requirements of the subscribed capital**

A bank may be established with a minimum of HUF 2 billion as subscribed capital, which is required to be paid entirely in cash. However, only 50 per cent of the subscribed capital must be actually paid up and be available when the bank applies to the FIS for a founding licence. At a later stage of the establishment procedure, when the bank applies for the operational licence, the entire amount of the subscribed capital must be paid up.

In addition, the subscribed capital of the bank may only be effectuated as a cash contribution i.e., in-kind contributions are not allowed during the operation of the bank. Any increase in the registered capital of banks may only be carried out via cash contributions regardless of the form of the capital increase (i.e., whether it was carried out by the issuance of new shares or by a conversion of excess capital into subscribed capital).

### **2.3 The ownership structure of banks**

A crucial point in the ownership structure of banks is any significant interest, which the Banking Act defines as a shareholder i.e.:

- a) holding at least 10 per cent of the shares or the voting rights;
- b) holding powers to appoint or remove the majority of the members of the board of the directors or the supervisory board;
- c) who may exert influence on the operation of the bank as stipulated in the articles of association or in agreement.

According to the Banking Act, no entity (natural person or legal entity) may acquire more than 15 per cent of the subscribed capital or the voting rights of a bank with the exception of the Hungarian State, other credit institutions, insurance companies, investment companies and the National Deposit Insurance Fund.

For those entities, however, which are allowed to increase their interest in the subscribed capital (or the voting rights) over 15 per cent, the Banking Act requires the permission of the FIS in the event that their interest (voting rights) would exceed 15, 33, 50 or 75 per cent respectively.

## **2.4 Licensing of banks**

Many aspects of the operations and the internal organisation of banks are required to be licensed, pursuant to the Banking Act, the most important of which are the founding and the operation licence. Both of the above licences must be obtained during the establishment procedure of the bank.

The application for a founding licence of a bank must contain documents that enable the FIS to render a well-grounded decision. These include:

- a) the articles of association of the bank;
- b) the document containing the anticipated area of operation;
- c) the certificate that at least fifty per cent of the amount of the subscribed capital has been paid up and is available;
- d) description of organisational structure, system of management, decision-making and control if such is not contained in detail in the articles of association,
- e) in case of applicants with a seat abroad, a declaration on the applicant's authorised delivery agent and such agent must be an attorney or a law firm registered in Hungary or the applicant's bank representative office in Hungary;
- f) in the case of a financial enterprise, a certificate that the enterprise meets the personal and material conditions required.

In addition to the founding licence, an operation licence must also be obtained by banks. Credit institutions shall submit the following documents along with the application for the operation license submitted to the FIS:

- a) proof of full payment of the subscribed capital,
- b) if all or part of the assets specified in the previous paragraph have been used, evidence or a statement declaring that such expenditure was made in connection with foundation or the commencement of operations,
- c) information regarding each owner of the credit institution having a minimum of five percent shareholding or voting rights,
- d) a business plan for the first three years, and evidence regarding the fulfillment of the personnel and material requirements necessary for the operations,
- e) the general contracting regulations and code of practice for the activities planned to be performed,
- f) a statement specifying the date proposed for the commencement of operations,
- g) a statement from the National Deposit Insurance Fund, and in respect of a credit cooperative a statement from a voluntary institution protection fund in addition to the aforementioned document, on the granting of membership to the applicant,
- h) a statement specifying the state compliance with respect to data disclosure obligations as prescribed in or on the basis of legal regulations, as well as the results of the tests of the computer software used for such disclosure of data,
- i) the scheme of accounting policy and detailed accounting system,

- j) a statement evidencing the direct connection to the transfer system for clearing transactions between credit institutions and an auditor's approval on the computer system (software) used for such connection,
- k) a statement on the direct or indirect connection to a transfer system for international clearing transactions if the financial transaction services provided involve foreign currencies,
- l) a statement on the joining of a central credit information system approved by the FIS,
- m) the order of procedure, as approved by the executive board, to be applied in the event of an emergency situation which would have the potential of seriously jeopardizing the liquidity or solvency of the credit institution.

The Banking Act requires a licence not only for the establishment and the commencement of the bank's operations, but also for the modification of its scope of activities. Furthermore, a licence is necessary for the merger, demerger, amendment of the articles of association, acquisition by the bank of its own shares in a proportion which ensures a significant interest, or for the increase of shares. A licence is also required for:

1. the election or appointment of senior officers;
2. the performance of financial service activities through another entity authorised to mediate financial services;
3. the foundation of a representative office, branch office in a foreign country;
4. the acquisition of a controlling share in an enterprise qualifying as a non-resident;
5. the transfer of the deposit holdings and the contracts for repayment of monetary instruments (deposit holding transfer);
6. the exemption from the obligation to maintain a transactions register;
7. the provision of liquidity and risk management services; and
8. the cessation of the bank's operations.

## **2.5 Licensing changes, mergers and demergers**

For transforming a bank into a different type of credit institution, the regulations concerning the establishment are applicable. Banks operating as companies limited by shares (and not as branch offices) may only merge with credit institutions operating in the same company form. Financial enterprises may also be acquired by a bank.

In the case of a merger of credit institutions (takeover of a financial enterprise), the following documents must be submitted, together with the application for the license:

1. the merger (takeover) agreement;
2. the transformation plan;
3. the draft balance sheet;
4. the asset and liability holdings (authenticated by an auditor);
5. all documents stipulated in the Banking Act required for licensing the scope of activities to be performed; and
6. in the case of a merger of credit institutions, the data from which the existence of the condition stated can be ascertained.

The licence issued by the FIS for the merger (takeover) of financial institutions does not substitute the licence required from the Economic Competition Office.

## **2.6 Ownership interests in other financial institutions**

The rule that a single owner may not hold more than 15 per cent of the subscribed capital of a credit institution is intended to limit interlocking ownership structure. A bank obtaining ownership in another credit institution is not subject to this regulation as mentioned above. In this respect, the Banking Act grants broad opportunities for banks to acquire interests in other credit institutions, the only limitation being that, in the case of such mergers, the subscribed capital of the general legal successor of the bank acquiring the other institution cannot be less than the amount of the guarantee capital of the merging credit institutions prior to the merger.

## **2.7 Regulation on the prudent operation of banks**

The Banking Act provides for the mandatory amount and the reduction of the equity capital and sets forth ratios relating to the guarantee capital and the general reserves of banks. A separate chapter of the Banking Act regulates the capital adequacy of banks, which involves limitations on the assumption of risks and transactions. In accordance with the corresponding EU directive (92/30/EEC), the Banking Act risk groups relating to, among other, large exposures, acquisition of ownership, real estate transactions.

Banks are required to qualify their assets on a coherent system of evaluation which is also based on the relevant EU norms. On the basis of such evaluation, the Banking Act provides for those percentage ratios of the total value of the assets which must be withheld by the banks as various types of reserves. For the challenges stemming from the merger-wave on the financial market, a part of the regulation response of the government incorporated the Banking Act is the definition of the "bank group" and the implementation of consolidated supervision measures.

## **2.8 Regulatory and supervisory rules**

With respect to regulation and supervision considerations, the movement toward an integrated supervision system was set forth in detail in the update of the Hungarian Banking Section of the International Law Office in April 2000 issue.

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