

Corvinus University of Budapest  
Faculty of Business Administration

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CLP 4/2015

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Some thoughts on the issues in banking  
regulation

by

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**CORVINUS LAW PAPERS**

ISSN 2416-0415

## Corvinus Law Papers

CLP – 4/2015

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Corvinus Law Papers – Editorial Board  
H-1093 Budapest, Fővám tér 8. II/240., 242.1

### Publisher:

Corvinus University of Budapest  
Faculty of Business Administration  
H-1093 Budapest, Fővám tér 8.

### Responsible for the edition:

Dániel Deák, Professor of Law

ISSN 2416-0415

Regular and Irregular Banking Regulation  
Some thoughts on the issues in banking regulation

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What is 'irregular banking regulation'? And: why is irregular a regulation?

These are the two main questions this analysis tries to launch and examine – at least formulate some legal issues for further consideration, discussion and research.

The banking regulation has different aspects to examine.

One traditional way to look at the nature and characteristics of banking regulation is the *method of regulation*. The method used by the different countries could be classified as classic or universal. The classic banking regulation includes the three major territories of deposit taking – financings – account keeping and payment methods (used this 'trias' in a wide context). Different securities dealings shall be added to get into the field of the universal banking regulation. The major *legal* difference between these two types of lawmaking is the different levels of liability and legal consequences. Besides the legal aspects the historical (economic and social development driven) and the economic questions are relevant to describe by scholars of those fields as it is a frequent question to be heard: why this/that country has one or the type of regulation for the banks? The answer is mainly not legal but historical and economic. The legal examination is relevant in analysing the role of the lawmaking state. As a consequence it might lead to very different legal opinions and as such it might generate legal discussions.

Another way to look at the nature of the banking examination is from the side of (a) the relevant transactions and (b) the financial institutions regulated to operate in a given country.

This type of analysis raises the question (especially concerning the transaction regulation) of the borders between different legal fields, their type of regulation etc. In other words: the *changing limits of legal fields*. The financial law fields have open end towards the law on economic competition (covering major operational issues for the financial law fields) the civil

law (concerning the transactions) the state administrative law (the role of the regulatory government agencies) the law on accounting etc. There are mixed legal research issues including both public and private financial law. The focus could be on either – and it results in subjective weighting of the different regulatory elements belonging to different legal fields. As a consequence, the classification might be closer to public or private financial law 'box'. (For example: the question of market supervision in banking covers competition law issues, banking law issues – might cover state administrative law issues. The possible players are state organisations – but belonging to different lines of the structure of the state organisations; e.g. competition office, banking supervisory organisation. The relations to be examined are regulated by different law – however they have to be applied jointly.)

Going even further in examination, a regulatory method can be detected as relatively easy and concise for legal analysis: the different issues of *regulated industries*. This term has been developed in the economics and later adapted in law. The legal meaning has become unified through the European Union Directives enacted for the financial sector in the last few decades. As a consequence, any legal research may cover the different roles of the state as (a) a law maker, creating high level and framework type norms and (b) a supervisor of the regulated market. Most of the research in this field concentrates on the supervisory role of the state in different historical settings. It examines and analyses the different possible state organisations; their power given by the lawmaker state for this purpose and their legal relations towards other relevant state organisations. These legal relations include operational issues between different state organisations, subordinated status, obligatory or non-obligatory joint operations and decision-makings etc. This field of legal research contains more elements from public financial law regulations than from civil law issues.

To answer the above questions one must check the different ways and roles of state intervention into economy, regulation and transactions. Checking the different roles of the state means to examine different legal relations on the fields of both public and private law – and not only meaning public and private finances. Besides the characteristics, the special activity and the institutions of the 'regulating state' in finances needs analysis.

Two remarks from the author to introduce the followings.

This paper will concentrate only on few regulatory fields; the goal is to bring into light some important issues and problems in finance regulation rather than analyse those in details.

The focus is on the Hungarian regulatory issues with occasional outlook to – mainly European Union based – international scenarios.

The last more than twenty years of Hungarian finance market – and banking – regulation may be classified according to various features; however this summary will follow a special timetable which is: the timing and sequence of special regulations.

The first phase commences with the early bank regulations in Hungary; which were based on the planned economy legal rules.

The second phase deals with the major issues of the first legal steps of the law-making state towards the establishment of market economy rules.

The third phase in time – overlapping partly the fourth – covers the bank privatizations mostly focusing on the different 'faces' of the state.

The fourth phase – even at present – shows the legal harmonization efforts towards and in the European Union.

A fifth – and special – phase may be devoted mostly to questions of the regulation which followed the 2008 financial crisis and its post-history.

Just looking back to the above framework it is astonishing how many things happened during a historically short moment of twenty-some years and how much issues one can detect in the Hungarian bank regulation even in this very short historical 'seconds'. That is why the goal to analyse this epoch remains a goal – no serious legal research may be carried out; especially looking at the post-2008 years the author cannot go further of data collection and to formulate possible research questions.

## I. First Phase: The Planned Economy Period as Limited Regulation in the Absence of Markets

First issue: the missing two-tier banking system

The planned economic system assigned all economic transactions to the central bank which resulted in the missing banking industry to simplified financial transactions based on the word-by-word copies of applicable laws. Retail and corporate banking could have been detected in a limited way.

The retail banking activities were carried out by one state enterprise (OTP) and covered in a 'nutshell' deposit taking, personal and consumer loans, housing financing and very strongly

controlled and limited foreign exchange. The transactions' regulations were covered in the Civil Code.

The so called corporate banking activity was carried out by the central bank. The transactions and the civil law liabilities one could have found in the Civil Code – but the 'business' type of financing decisions came through the central bank and were politically based.

Second issue: the special institutions in the economy

The economic participants followed the form governed by the law on state owned enterprises. In the 1980's the so called 'joint venture company' was a step made towards the weakening of the planned economic system and starting for the market economy.

Similarly the limited regulation of 'waking up' the bonds as securities in the early 1980's and making possible small business (partnership-types operations) activity showed some signs of accepting private business and financial activities. The bond issues (starting exclusively from the sphere of the state owned enterprises) and the joint venture company establishments (even though the average establishment procedure going through a double – Ministry of Finance and National Bank of Hungary – licencing procedure was more than 400 days) showed a nice colour in the last years of the planned economy system.

The central bank had very strong role beside having the traditional central bank functions. It was a currency authority and an active 'banker' for the corporate (i.e. state owned enterprises) sector. Having the legal power of a government authority organisation – the central bank operated as the highest level authority in the economy.

The financial institutions covered the retail finance (OTP) the state owned enterprises' local operations (National Bank of Hungary) and their foreign financial contracts (MKB). The state owned investments and financing were handled formally from the (multi-named) MFB - the state owned development financial institution with the remark that the decision-making came from the ruling party's hierarchy.

Third issue: the existing legal framework for transaction ruling

The compulsory regulations of the (otherwise mostly flexible) Civil Code had to be followed by the state owned enterprises in their financing contracts. Some alteration was found in the foreign trade contracts because of the foreign contracting parties.

## II. Second Phase: First Regulatory Steps to Implement Market Economy Rules

First issue: the banking model regulation

In the lack of previous banking/financial regulation the choice of the law-maker state between the classic and universal bank model regulation was ad hoc. Following the first (universal) bank regulation, the system was burdened with subsequent changes between the models.

Second issue: the establishment of the two-tier banking system

The two-tier banking system was established earlier in 1987 through a government resolution than the issue of the first banking act (1991). Three major commercial banks were created covering the whole economy. It resulted in a (a) complicated company structure – dating back to the 1875 Commercial Code, (b) manually governed bank operations – influenced by politics, (c) strong influence exercised by the central bank was increased thanks to the individual bargainings (for extra operational rights especially in the field of currency policy) between the new banks and the central bank.

Third issue: the regulation of commercial banks activity

The commercial banking activity had started earlier than the regulation and establishment of the banking supervision. Besides the very strong powers concentrated in the hands of the central bank were decisive for a long time and resulted partly in the unclear sphere of activity of the banking supervision.

The first law (1991) gave a the legal framework for the starting Hungarian commercial banking. The next significant regulatory step (1996) was designed for the European Union legal harmonization and contained the summary of the then effective EU banking directive – still effective (with many modifications).

This start-up regulation of the commercial banking activity has opened many discussion topics.

A theoretical question has been relevant throughout the different legal systems (and as a result in the banking law, too): how wide is the scope of banking transactions or: what are the limits of the regulation of a banking transaction? Which is the proper legal regulation for the banking transactions? – Is the civil law the governing general rule? Or: is it the banking law which wears all the significant features of a regulated industry? As always, the research goes somewhere in between of the the two borderline regulations – the result depends on the weight of the elements of the applicable legal branches.

Fourth issue: 'market regulation by the state': is it impossible?

The dilemma of 'making the fish out of the fish soup' is/was relevant because no previous example existed for the 1990's transforming economies in Eastern Europe. For the transformation from the planned economy to the market economy, those countries had to adopt the late twentieth century results from all over the world. That was an unknown field for the law maker state – and for every participants in the economy. The regulator of the unknown field became the state – partly because no-one have ever questioned the state as the maker of the transitional period's regulations. Obviously the road was to know, analyse and adopt the rules of the market economies around us. On the other hand: the law maker state could not run from its shadow: had to 'cook' with what and who it had.

Fifth issue: the effect of the international financing on the Hungarian regulation

It is a fact that the international financial transactions had quick and strong effect on the domestic transactional practice. Their effect on the regulation was also strong – but more questionable as to the results were concerned.

Two definite positive features may be mentioned: one was the adaptation and implementation of the modern international financial instruments into the domestic documents and the other was the notion of risk management and its continuous and increasing application.

A negative or very problematic effect was the increasing number of anomalies and inapplicability of the two systems' (remains of the planned economy rules and the /mostly/ English law based financing legal instruments) joint application. The chaos of problems was possible to follow in that period's regulatory efforts.

### III. Third Phase: The Bank Privatizations

First issue: the different roles of the state in the privatization of the large banks

The Minister of Finance is the classic regulation in the Civil Code as the direct representation for the state in civil transactions (i.e. contracts) as in privatizations. The transitional rules (even before the first parliamentary elections in 1990) from 1989 specified another institution representing directly the state in privatizations – this was first the State Property Agency (later called: State Privatization and Property Management Company).

Beside the direct form of representation the state showed up many times 'wearing' different hats, showing its different 'faces', in other words represented indirectly through some other state organization. Some examples from the bank privatization rules for such indirect representation: different ministries not only from economic field, the Health Insurance Fund,



the Pension Insurance Fund, state owned companies, local municipalities. One could find combinations of the above state organizations as well.

Second issue: the bank privatization models

Classification may be made mostly for the first phase (1993-1997) large bank privatizations: commercial partner privatization, public issue of shares through the stock exchange, financial partner privatization and risk-sharing privatization – and a late comer in 2003: the application of public procurement rules (and problems!) and second level indirect state representation in banking privatization.

Third issue: a very special financial instrument and problem at the same time: guarantee undertakings by the state

This is not specific only for the bank privatizations – however the history of the guarantee undertakings by the state in the large banks's privatizations shows very typical picture of the state's privatization policy of those times. The first such case in bank privatization dates back to 1995. After most major privatization contracts contained a form of state guarantee – the very negative effect could be seen in the consecutive state budgets' numbers. The legal side of the problem goes back to the basic question: who is the state? Or: which state organisation will cover the guarantee (if it becomes necessary)? As the state had different 'faces' in the bank privatization process and there was no clear regulation to this effect – the solution to this problem could have been always a discussion topic within the decision-making state organisations.

#### IV. Fourth Phase: Legal Harmonization with the European Union Rules

First issue: regulations before joining the EU

The first steps were to identify the category: 'regulated industries' in the finances and start examining the relationship between the three financial sectors (banking, securities, insurance) existing regulations and the need for harmonized standard rules. The three sectors needed different efforts: the easiest to harmonize was in the insurance industry; banking needed to adapt the existing EU Directives and especially the state supervision rules; the securities market had been regulated in the EU (and also internationally) on the lowest level by far.

The banking act of 1996 has been from its issue (through the subsequent changes) a relatively stable and neutral framework law for the financial sector.

Second issue: regulations following the 2004 joining to the EU

One definite success of the EU regulation and its harmonization all over in the EU: the introduction and implementation of the risk management rules – however it came probably too late to influence significantly the 2008 crisis. Another feature of the EU regulation was the hundreds of changes in the Banking Directives from the 2000's continuously and to a large extent. It made practically impossible to follow up appropriately by the member states and had resulted in a regulatory chaos.

#### V. Fifth Phase: Certain Cases – Issues of the Irregular Regulation following the 2008 Financial Crisis

This phase is not yet appropriate to analyse the process but one can look at the regulatory instruments used by the law-making states in the regulated financial industry. However no classification of the used instruments may be made at this point of history.

The picture shows *unusually strong state intervention* – direct mostly but also indirect – into the financial regulatory field. This very special so called 'irregular' regulation is present both in the public financial law (strengthening taxation, limiting institutional and flexible framework regulation) and private financial law (directly intervening into contract rules) governed legal relations. However (a) the strength, (b) the direction and (c) the scope of the state regulation and the ratio is quite different in countries.

#### VI. The Irregularity in Banking Regulation – Why and What is 'Irregular' the Bank Regulation?

Irregular, because the examined issue is: *irregular capital accumulation* was generated in East Europe from the 1990's – as earlier mentioned: 'we make the fish out of the fish soup'.

Irregular, because the different legal branches have been changing; the *limits of legal branches change*. This has been an earlier non-detected history – the transactions consummated by the market players (whoever they are) according to different legal regulations. These regulations have not been harmonized – many times not even detected and as a consequence they generate further and more complex legal problems. Let us think –

among other examples – about the changed relationship between the regulated financial industries and the competition law or public administration law.

Irregular, because the *role of the state in the economy is irregular...* - whatever is the meaning of this 'irregular role'.

The different roles' nature is questionable: What are the different roles – owner / beneficiary, regulator / active market player, public authority / quasi-authority etc? All these roles are regulated (generally not focusing the state) in different legal branches meaning different powers, status within the state structure and as a consequence questionable (i.e. non-harmonized) rules for interaction.

*... and the role of the state in economy does not equal to the state regulation*

What does the state as law-maker regulate? Is the regulatory subject the property – including the regulation of privatization and reprivatization (or: nationalization, expropriation)? Or: is the regulatory subject the transactional rules of the market players? – If (at least partly) yes, how far can the law maker state intervene at the level of transaction? And putting such questions we slowly move out from the legal field...