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The Features, Background and Difficulties of Bank Regulatory Capital Requirements

SUMMARY: Credit institutions are the driving force and financiers of the economy. Due to the decisive role of credit institutions, issues related to bank regulation are surrounded by eternal debate and conflict. This publication aims to explore the aspects, problems and anomalies of regulatory capital requirements involving individual domestic and local credit institutions in the area of bank regulation. The author proceeds to examine the scope, reach and depth of regulatory capital requirements, especially their inadequate nature and problems related to application with regard to smaller, local credit institutions (principally cooperative banks). In addition, the publication addresses, with a view to the legal aspect of regulatory issues, the disharmonies of integration related to individual policy areas.

KEYWORDS: regulation, capital requirement, bank, cooperative credit institution
JEL-CODES: G21, G32, G15, F34

Today, bank regulation is an important and timely issue. It is hard to think of a person who does not have some sort of banking relationship. These relationships could involve the asset (credit) or liability (deposit) side. In today's world, payment transactions are inconceivable without credit institutions. Regulation raises considerations related to customers, the economy and society at large. For customers basic consumer protection interests emerge, whereas in economic and social terms stability is key. As stable institutions, credit institutions are the bedrock and driving force of the economy. However, lack of stability leads to distrust, losses and chaos which, as a result of the specific asset-liability structure, may trigger or intensify a self-generating process. Aspects of regulation may be multifaceted; however, considerations have emerged according to which bank regulation is unnecessary and should be avoided or restricted.

THE DEBATE ON THE NEED FOR BANK REGULATION

A few decades ago there were great debates on the need for and restriction of bank regulation (studies and articles, typically in the 1970s, 1980s and the first few years of the new millennium). By their very nature, these debates remained mostly theoretical (with the exception of a few practical, simplified and incomplete examples from Sweden and Canada).[1] The financial crisis of recent years unilaterally confirmed the dearth of practicality (or at least limited application). The opponents of bank regulation are advocates of so-called free banking. Free banking is characterised by the minor presence or even lack of bank regulation; with-

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in the framework of regulation the key is money creation, i.e. how it is or is not regulated. The approach calls into question the need for central banks and is based on the assumption that banks make absolutely correct decisions and the full value of laissez faire. Cited by *Nilsson* (Nilsson, 1981, p. 138), *Göteborgs Handels – och Sjöfartstidning* writes the following: "money and credit regulation should only be limited using a general regulatory principle".[2]

As *Rothbard* (2008) puts it: banks should be allowed to operate according to the same framework and conditions as all other companies, i.e. without interfering regulation. It is not the task of the government to regulate and keep banks under intrusive control. Rothbard considers one regulatory principle (by no means detailed regulation) acceptable: the obligation to maintain solvency, which must be required of the banks. Otherwise, the market will sooner rid itself of any institution which fails to comply fully with this requirement. *Vera Smith* (1990) points out that the liability of banks within the framework of free banking is high, higher than that of other businesses. However, their rights are not as comprehensive as those of businesses in other sectors. The reason for this lies in the nature of the activity, as banks deal with customer deposits which must be available for repayment on an ongoing basis.

Dowd argues at great length for these principles in several of his writings, in which he presents the unregulated self-operation of banks along the lines of logic and interests. In her paper, *Katalin Mérő* (2004) describes these arguments in detail. Dowd (2003) agrees that asymmetric information exists, one of the main arguments of those who argue for bank regulation, and accepts the need for internal bank monitoring and banks' role in terms of liquidity transformation. Nevertheless, in his view state deposit insurance, bank capital regulation, and the role of central banks as lender of last resort do not assist and facilitate prudent operation; on the contrary, he perceives it as an inhibiting factor in this regard. He relies on the sound discretion of bank managers and the assumption that they intend to operate in the long run and, accordingly, would like to retain their depositors and maintain their trust.

The author himself agrees with the need for bank regulation, but challenges its scope, reach or form on the basis of various considerations. Information asymmetry and depositor protection is a matter of regulation. Information asymmetry exists in all companies in some form and to some extent; it comes into focus if one's savings are entrusted to the party concerned. Asymmetry can be reduced in two ways. On the one hand, there is the supervisory authority itself and its activity: even if it does not provide detailed and more information, the fact results in security that asymmetry does not entail secrets or lack of access to information worth knowing. At the same time, the hunger for information is somewhat alleviated by the banks' disclosure obligation in effect since 2008, under which credit institutions are required to disclose numerous data regarding their activity and capital position, which enables comparability, while in the case of expertise (even in the form of an adviser), hitherto unknown individual data allow credit institutions to be evaluated from a different perspective and in greater depth.

In recent years, depositor protection has been an important aspect of bank regulation on an EU level. The features of the deposit insurance system and protected limit were the subject of serious debate. Essentially, two types of system exist, ex post and ex ante, meaning that if a negative event occurs, banks make payments, from which customers can be compensated, or payments are made in advance, the amount of which is available at any time. Furthermore, deposit protection funds can appear as institutional investors on the financial and capital market. Some countries have combined the two basic scenarios, forming a mixed system.

Depositor protection is key not only on an individual customer level and important not only from the perspective of bank panic, bank failure, systemic bankruptcy or even economic stability, but a key test criterion in terms of cross-border activity as well. The special significance of this, apart from the nature of the deposit protection system, emerges in the deposit protection limit. When a branch office is established via cross-border activity, the institution does not settle down completely and does not establish a new institution in a given country; however, its activity can be significant. The scale of institutional activity is not necessarily important as, according to a broadly defined consumer protection aspect, customer protection must actually be provided. The limit – precisely at times like this – is even more important. Establishing a single EU deposit protection limit among the varying income levels and financial circumstances of Member States is on the one hand difficult, and on the other hand unequal. The current limit of EUR 100,000 shows differing rates for each Member State, as in Hungary it covers the vast majority (more than 90 per cent) of total deposits for natural persons. However, there are Member States where this value is much lower. The limit, considered high by Hungarian standards, was set by the EU as a result of the crisis in December 2010 (Coreper, 2011). The crisis has brought about change in terms of deposit protection also in the sense that a clear shift has occurred to ex ante schemes, at least to a certain limit.

Another aspect of bank regulation among supporters of bank regulation is the issue of bank failures. Katalin Mérő (2004) presents in detail the path from bank panic through bank failure and contagion to systemic bank crisis. The specific asset-liability structure inherently implies the possibility of bank panic as, in the event of teetering confidence, depositors withdraw their savings, reducing or even eliminating liquidity. In addition to the above, a banking panic can result in costs and losses, even in the case of a minor impact and problem. Prompted by impact, reach, loss of confidence and other factors, bank panic may spread to other banks as well. In the case, the crisis at hand has reached systemic proportions. At this point, as Katalin Mérő points out (2004), not only are individual costs incurred by the banks, but losses are suffered on account of depositor compensation, loss of confidence and the costs associated with restoring functionality, which is to be construed as a cost to society.

The resulting disadvantages and problems can not only be interpreted in terms of costs or losses, as the betrayal or loss of trust is a serious factor which takes a long time to remedy. Numerous elements of the payment and financial sector are closely associated with the principle of trust. The stability of the economic and financial system is closely linked in principle and practice.

IMPLICATIONS OF BANK REGULATION FOR CAPITAL REQUIREMENT

Bank regulation is an important tool for and responsibility of every country. Hungary sees to it accordingly; the role and significance of bank regulation in Hungary in the last one to two years has been treated as a key priority even from the perspective of consumer protection. The essence of domestic legislation in this respect is to limit the possibility of unilateral contract modification (by banks) and increase information requirements. The regulatory issues associated with the socially oriented foreign currency mortgage repayment and the above aspects of consumer protection have received a great deal of media attention, have a major impact on a certain part of society and are crucial to credit institutions as well. Credit institutions, however, have been and are being affected in the long term by many other international and EU regulatory changes more fundamental and comprehensive than those mentioned above. However, due to their technical nature, they are receiving and have received less media coverage. These regulatory aspects involve capital requirement rules. They have had a major impact on banks, increased transparency, and essentially via mathematical models transaction risk, i.e. the probability of default and the capital requirement value have started to converge. The previous regulatory provisions have been replaced by risk-based regulation. Several articles and papers evaluating this topic have been published. Accordingly, this article does not aim to provide a description or methodological analysis thereof. It is important, however, to examine other aspects of the regulations, namely their utility, consequences, the situation of their application, their integration into the domestic environment and the related consequences and problems.

Bank regulatory capital requirements were first manifested in 2004 in the form of the Basel II international recommendations. It was based on these that the EU regulatory capital requirements were drafted, and ultimately adopted in June 2006 by the name of Capital Requirements Directive[3]. Regulation adopted the Basel II recommendations without any significant changes. However, there was a major difference between the two approaches. The international recommendations applied the regulatory recommendation to internationally active banks, whereas the EU regulation applies to all credit institutions; in fact, the regulation and application requirement was extended to include investment firms as well. By doing so, a process was launched which in my view has a number of negative effects.

SPECIFIC PROBLEMS RELATING TO THE PHILOSOPHY AND APPROACH OF BANK REGULATORY CAPITAL REQUIREMENTS

The role of regulatory capital requirements in terms of system innovation and the huge strides towards modernity are undeniably positive developments. However, regulation also entails several negative consequences. One of its most relevant and noteworthy aspects is that it is based on past data and, along the basic operational logic of credit institutions, amplifies pro-cyclicality and its effects. The uniformity of regulation acted to enhance competition and increase transparency, while also facilitating the fulfilment of group-wide supervision. Uniform regulation, however, has a number of negative effects as well.

The standardisation of bank regulatory capital requirements started in the framework of the Basel international recommendations, which expanded its scope to include internationally active banks. In terms of their core activities, scale and nature of service (wide customer base, wide range of transactions, large geographical size, etc.) these institutions are comparable and can be treated using a standard approach. Their activity transcends borders and they can be referred to as major even by international standards. By contrast, EU regulation, as mentioned, was expanded to include all credit institutions and investment firms. Accordingly, the smallest cooperative credit institutions came to be subjected to the same assessment, regulation and conditions as the largest international banks.

In themselves, the institutional dimensions suggest that, due to the scale, complexity and nature of the portfolios, applying the same models involves a number of risks. Several critical articles and analyses[4] have been published to this effect. Consequently, at present I would like to point out basic background elements and environmental connections. Countries operate on the basis of varying economic policy principles and objectives, even if the formulation of specific elements is similar. In establishing EU regulations for the banking sector, differences between Member States and unique characteristics make themselves strongly felt. (From 2003, as a staff member of the former Ministry of Finance and currently of the Ministry of National Economy, the author had the opportunity to monitor the amendment proposals, background, lobbying processes and consequences of uncertainty during the preparation of and negotiations relating to several financial services regulations, and was actively involved in all phases of EU and Hungarian professional work.)

Of course, EU objectives, i.e. the freedom to provide services, the free movement of capital, comparability, and increasing competition and transparency are all important considerations and cannot be ignored. However, after a certain point of depth, the standardisation and uniform regulation of these as a fundamental tool entails disadvantages, difficulties and problems. This can be observed in bank regulatory capital requirements as well, as the capital requirements for lending, market and operational risks are specified in several hundred pages of detailed regulation. Increasing bank group transparency and achieving easier implementation of group-wide supervision are important considerations and point to cost reduction and increased efficiency. However, they can not override the efficiency of the specific activities of individual credit institutions and the adequacy of their functions. Conversely, the in-depth regulation of standard bank regulatory capital requirements implies several difficulties in terms of application and comes at a price.

These differences and difficulties regarding application stem from the varying economic histories, economic policies, institutional environments and political emphases, which all have a fundamental impact on transactions, customers, related perceptions and the application of any beneficial regulations available. Small and medium enterprises can be mentioned as the most typical examples in this regard. Although the size and approach of these varies among countries and Member States, special attention is paid to them everywhere. However, their weight and significance from the aspect of GDP, employment and financing are extremely heterogeneous. In Hungary, the proportion of small and medium enterprises is very high, especially that of micro-enterprises. Accordingly, in relation to the institutional environment it can be asserted that the process, level and quality of state guarantees for financing small and medium enterprises varies by country. And it is the incorporation of these which fundamentally determines SME financiers, i.e. the credit institutions as well. Accounting regulations are another important point of contact. Regulatory capital requirements rely heavily on accounting evaluation, accruals and regulation. However, accounting regulations are not nearly as uniform as the regulation of capital requirements. Accordingly, major discrepancies are to be found between Member States (deadline for late payment, the accrual and definition of impairment and provision, specific and portfolio-based evaluations, etc.).

A detailed and virtually comprehensive foundation involving bank risk calculation, risk management and regulatory capital requirements was prepared in the framework of the Basel recommendations. Its advantage lies in the nature of a recommendation, i.e. it is possible to deviate from it and no application requirement applies. The leeway for individual countries is given; at the same time, a shift may be made toward a form of regulatory capital requirement (more accurate risk assessment) which professionally speaking in many ways represents progress and development. Its nature of a recommendation allows regulation, with regard to the differing economic, economic policy, economic historical, and consumption patterns as appropriate for non-EU countries, to be applied only to internationally active banks.

However, the regulatory capital requirements of the EU are binding; thus, the uniformity of regulation in its entirety appears as an obligation to Member States. It is a matter of fact that during the negotiations (as an expert of the Ministry of Finance, the author had the opportunity to act during negotiations as an advocate of Hungarian interests and was able to track this process with regard to other Member States), the quality and purpose of the Directive in several instances was compromised by the incorporation of the differing interests. The basic problem is that this level of regulation results in difficulties regarding application on the level of Member States and institutions, and that amendment proposals had to be inserted (as incongruous or even contradictory regulation) without leading to the collapse of the Directive. Accordingly, 'solutions' of a forced nature were included in the Directive and in application practice. An example of this is the high degree of discretion[5], on both a national and supervisory level[6].

LEGAL AND APPLICATION PROBLEMS RELATING TO BANK REGULATORY CAPITAL REQUIREMENTS

The previously mentioned discrepancies could be further elaborated; however, the social, economic and consumer protection reasons and consequences are already apparent. The higher costs of credit institutions are passed on to customers in the form of pricing, which has a boomerang effect both on an economic and social level.

In further negotiation of the issue, one of the main problems must first be clarified, that EU regulation may be broken down into two main aspects: common regulation and community regulation. In community regulation the issue of uniformity does not even arise. In the area of common regulation, uniformity and the depth of regulation varies; accordingly, the regulatory background differs across EU Member States. There are several aspects of this in Hungary. On the one hand, the extent to which accounting regulations can be considered uniform does not match the uniformity of bank regulatory capital requirements. Accordingly, there is a lack of sufficient overlap between interdependent regulatory elements. The other cardinal element in terms of bank regulatory capital requirements is the regulatory background linked to elements of credit risk mitigation. These mitigating elements were significantly expanded upon the initial application of the regulatory capital requirements which came into force in 2008. However, as the regulatory background does not ensure the fulfilment and completeness of conditions, the expanded regulation and its permissive nature are coupled with a lack of applicability. Highlights include the absence of certified public records, the anomalies of the land registration system, the moratorium on (property) auctions, and the disharmony associated with on-balance sheet items and the compensation concept in the Civil Code.[7] This is responsible for the fact that individual items are accepted and admitted in line with the practice of credit institutions, and that on the basis of banking practice the transaction is backed. However, this does not hold true from the standpoint of determining capital requirements. As a direct consequence, this manifests itself in pricing and the higher risk value entails higher interest and fees to be paid by recipients of financing. This is then passed onto consumers; thus, the social and economic implications are clearly given. At the same time, the regulatory background was established with a fundamentally different purpose, reason and set of logic.

It is not always conceivable for the regulatory background to necessarily adapt to other regulation, in this case to regulatory capital requirements, which in turn is detailed and bound in content and nature on the basis of the text of the EU Directive. At the same time, cost implications surface among the consequences of all regulation and regulatory changes. Consequently, the legislative intent may exist; however, the lack of funding may constitute a barrier, which is especially true in a period wrought by economic and financial crisis. Naturally the cost aspect is also affected by whether the costs at issue are one-time (set-up, preparation, etc.) or ongoing (operational, upgrading, etc.), and whether external effects determine the outcome of the decision. Individual decisions are determined by economic and political factors; accordingly, the emergence of negative externalities has a forced impact, whereas positive externalities act as a sort of incentive on decision-makers.

Fundamentally, therefore, it is necessary to think through the system of interdependency and related consequences. The international level was determined in the form of recommendations. Accordingly, the option of divergence is given, and the paths of adaptation can automatically be more widely interpreted. The applicable EU regulation, the Capital Requirements Directive is binding in both depth and nature. Consequently, this level of regulation should already include the connections, nature, reach and scope of the regulatory background. This would be the purpose of impact assessments preceding regulation. Typically, however, insufficient attention and time is spent on these. In fact, the focus is almost exclusively on the regulatory part. However, in many cases the only option for solving the problem is taking account of the set of problems involved in EU level regulation, the establishment of harmony, and the lack of coordination (common law, aspects of Community law, etc.).

SPECIFIC PROBLEMS OF BANK REGULATORY CAPITAL REQUIREMENTS RELATING TO COOPERATIVE CREDIT INSTITUTIONS

Criticism regarding the depth of regulation may be formulated from the institutional aspect removed from the areas of general regulation and regulatory background. As far as the entire category of credit institutions is concerned, there are big differences within countries as well, as cooperative banks represent an entirely different centre of gravity and situation. However, they are subject to the same capital requirement rules as internationally active banks.

Accordingly, continuing the analysis, in Hungary it is necessary to focus on the functional, size and activity related and other discrepancies among banks and cooperative banks. In the area of specific tasks, market role and expectations expressed by customers, cooperative banks are narrowly delimited and have limited room for manoeuvre. The basic purpose and function of cooperative banks is to provide financial services in geographical locations where banks, for reasons involving economies of scale, would not and do not open bank branches. Owing to their location, their customer base, the services required and the options of cooperative banks are very limited. Regardless of the fact that, as businesses and as financial service providers, their fundamental aim is to maximise profit, the duties of cooperative banks and (instead of classical economic principles) their emerging purpose is to serve the identified market segment, i.e. the population of smaller settlements in the area of financial services. Accordingly, the order of magnitude in terms of amounts is smaller, and the complexity of transactions is typically low. Retail customers and municipalities constitute almost the entire clientele of cooperative banks. The category of retail customers also comprises sole traders, farmers, and micro and small enterprises. Rural financing and the financing

Table 1

DISTRIBUTION OF THE LIABILITIES PORTFOLIOS OF COOPERATIVE CREDIT INSTITUTIONS AND BANKS

	12. 2009	3. 2010	6. 2010	9. 2010	12. 2010
Total liabilities (HUF bn) – Cooperative credit institutions	1,602.6	1,612.2	1,639.9	1,662.6	1,733.6
Customer deposits	1,328.9	1,335.7	1,347.7	1,375.9	1,450.4
Deposits from monetary financial institutions	18.4	18	17.5	15.5	16.4
Loans taken	97.5	106.3	116.6	110.3	112.6
Other liabilities	43.8	34.0	37.0	36.8	31.1
Equity	114.1	118.3	121.1	124.2	123.0
Total liabilities (HUF bn) – Banks	28,996	28,377	29,829	28,689	28,157
Customer deposits	11,946	11,720	11,693	11,533	11,601
Deposits from monetary financial institutions	5,190	5,193	5,727	5,508	5,237
Loans taken	4,233	3,859	4,057	3,844	3,689
Own-issued debt securities	3,132	2,923	3,043	2,926	2,872
Other liabilities	1,450	1,504	2,088	1,693	1,633
Subordinated financial liabilities	667	653	686	689	648
Equity	2,378	2,525	2,535	2,496	2,477

Source: Hungarian Financial Supervisory Authority (2011)

Table 2

DISTRIBUTION OF THE ASSETS OF COOPERATIVE CREDIT INSTITUTIONS AND BANKS EXPRESSED AS A PERCENTAGE

(per cent)

	12. 2009	3. 2010	6. 2010	9. 2010	12. 2010
Total assets (HUF bn) – Cooperative credit institutions	1,602.6	1,612.2	1,639.9	1,662.6	1,733.6
Cash and settlement accounts	3	2.7	2.8	2.8	3.1
Marketable securities	20	18.3	17.7	18.5	20.9
Investment securities	5.9	7.6	8	7.7	7.5
Central bank and interbank deposits	20.6	20.5	19.7	19.5	20.2
Loans	44	44.3	45.5	45	42
Property interests	0.6	0.6	0.6	0.6	0.6
Other assets	5.9	6	5.7	5.9	5.7
Total assets (HUF bn) – Banks	28,996	28,377	29,829	28,689	28,157
Cash and settlement accounts	1.8	2.0	2.2	2.1	2.0
Marketable securities	12.2	11.2	12.1	12.6	12.6
Investment securities	10.5	12.7	12.1	12.6	12.6
Central bank and interbank deposits	5.7	3.9	4.5	4.7	5.4
Loans	62.7	63	63.8	63	64.2
Property interests	2.2	2.3	2.4	2.4	2.5
Other assets	4.8	4.7	4.7	4.8	4.4

Source: Hungarian Financial Supervisory Authority (2011) of agricultural areas entails specific tasks for cooperative banks. Parallel to this, the composition of their portfolio is unique as a result. Upon examining the data of *Table 1,* the differences are clearly visible, a few of which are selected and presented as follows. The retail loan portfolio at cooperative banks is 43–45 per cent; the corresponding figure for banks is 36–39 per cent. Based on the data processed, cooperative banks have no international contact, whereas the corresponding rate for banks is 10–12 per cent. Customer deposits comprise 80 per cent of liabilities for cooperative banks, and 40 per cent for banks. Loans constitute 42–45 per cent of the assets of cooperative banks; the corresponding rate for banks is 62–65 per cent. *(See Table 2)*. This is the case for both institution types in spite of having identical activities and level of intensity, as, relative to liabilities, the equity rate of both institutions is identical. In other words, both qualitative and quantitative analysis clearly demonstrate a major gap in the goals, customer base and activity indicators of the two institutions. *(See Table 3)*.

However, the statutory obligations of the two institutional groups are the same. In order to fulfil these, cooperative banks have carried out several developments; they have developed their infrastructure and IT and registration systems, and continuously spend money on maintenance as well. A typical example is meeting the disclosure obligation, which, as an electronic information requirement, also applies to credit institutions without a website. However, awareness of these documents is extremely low and their readership is very small. There is only a minimum or no decrease in the regulatory

Table 3

DISTRIBUTION OF THE LOAN PORTFOLIOS OF COOPERATIVE CREDIT INSTITUTIONS AND BANKS

(per cent)

	12. 2009	6. 2010	12. 2010
Loans (HUF bn) – Cooperative credit institutions	762	805.6	796.8
Non-financial corporations and sole traders	52	54.3	54.6
Retail loans	45	42.8	42
Loans (HUF bn) - Banks	18,874	19,928	19,086
Non-financial corporations and sole traders	35.6	33.8	34
Retail loans	36.4	38.1	39.3
International loans	12.2	12.4	10.7

Source: Hungarian Financial Supervisory Authority (2011)

Table 4:

CHANGE TO THE MINIMUM CAPITAL REQUIREMENT BASED ON PRELIMINARY ASSESSMENTS*

(per cent)

Risk/Method	QIS 3	QIS 5 Standard method	QIS 5 IRB
Credit and market risk	+1.6	–9.1	–30.2
Operating risk	+10.6	+14.0	+7.5
Total	+12.2	+4.9	–22.8

**Note:* Indicated changes relative to the value of the previous regulation.

Source: Vörös (2006)

capital requirement available to the institutions.[8] Especially given that simple methods are used by cooperative banks and, although reduction of the lending risk capital requirement is achieved, the operational risk entering the picture as a new risk significantly increases the level of capital needs. *(See Table 4)*

In addition, cooperative banks are exponentially afflicted by the negative impact, embodied by the phenomenon that the regulatory background integration related to EU regulatory capital requirements, as previously mentioned, fails to take place. It can be considered a cliché that legislation is never integrated; however, to do is akin to sweeping the problem under the rug rather than seeking the solution. In the present case, the lack of integration concerning the capital requirement rules and regulatory background leads to higher costs, prices and (indirectly) social disadvantages.

Clearly, all credit institutions in Hungary are adversely affected as a result. The extent varies according to institution size; smaller institutions, such as cooperative banks, are proportionally more adversely affected. The main reason is that, on account of their customer base, they are the most characterised by the presence of the function of claims related risk reduction. Furthermore, the ratio of real estate secured loans, due to the high proportion of retail (retail as well as SME) clientele, is high.

Compared to credit institutions, cooperative banks operate and provide their services according to fundamentally different features and conditions, as their goals, markets, customer base, demands on them and their functions vary. Cooperative banks, as small town financial service providers, typically operate without regard to principles of economies of scale. The market environment, the limited options for profit maximisation, and the limits on classical economic and economical decisions impact the rest of their decisions as well. Accordingly, in the course of the internal capital adequacy evaluation process, cooperative banks work using the simplest possible solutions and methods. These on the one hand can be factually ascertained from the risk reports (HFSA, 2011) of the HFSA, and on the other hand the cooperative banks, in complying with their disclosure obligation, acknowledge in their published methodological description that they use the simplest methodology.

Due to the higher numerical values and magnitudes, this impairs efficiency, and in terms of financial sector development shows a lower level. As increased efficiency determines pricing, reliable and stable operation, and active market participation, increasing efficiency is an essential aim. Since this clearly has not been achieved in the last three or four years using own resources, a sort of incentive appears to be necessary. If any sort of self-motivation existed, informal and regional (even micro-regional) cooperation among cooperative banks would be plausible, in which a few cooperative banks would take steps on the road to efficiency in the framework of an informal cooperation specifically designed to increase cost-effectiveness, infrastructural efficiency and enhance development potential. However, the chances of this happening, after several years of preparation followed by a four-year application period, are rather low. Accordingly, the only tool is legislative motivation, i.e. the formulation of a set of minimum requirements to support a smaller region-oriented, informal cooperation while maintaining existing cost levels in order to facilitate increased efficiency.

CONCLUSIONS

The system of financial institutions and specifically of the bank system, as Hungary's financial system is traditionally money market financed, i.e. bank-based, is the fundamental driving force of the economy. Its regulation, for reasons including supporting and financing the economy, depositor protection, avoiding bankruptcy, maintaining stability and confidence, and several other purposes related to the economy and economic psychology, is deemed necessary, which is clearly underscored by the financial crisis, context and scale of recent years. At the same time, the nature, extent and approach of regulation are very important, but it is conceivable that in certain cases it will not achieve its goal. The reason for this on the one hand is the treatment of internationally active large banks and small banks (including mainly cooperative banks) in the framework of the same regulation, and on the other hand the forcing of excessively detailed and uniform regulations across countries, thus resulting in many unnecessary costs, contradictions in application and conflicts. A multi-faceted regulation which accepts and supports the nature of individuality within the institutional group and takes account of the regulatory environment can achieve more results and the motivation to conform with it would be greater. Naturally, in this case, this implies fostering motivation, support, guidance and stimulation so that the institutions operating with constraints and limited by their capabilities avail of as many opportunities as possible, and use them to the benefit of the economy and society at large.

Notes

[1] Lakomaa, 2007

[2] Lakomaa (2007) also addresses these ideas and also quotes those concerned, "freedom, only restricted by the general law should be the sole governor of money and credit".

[3] Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions and Directive 2006/49/EC of the European Parliament and of the Council of 14 June 2006 on the capital adequacy of investment firms and credit institutions.

[4] Of the numerous critical articles, I would like to highlight a select few, most of which address Hungarian aspects, which can serve as a guideline: Erdős – Mérő (2010, pp. 239–245), Moore et al. (2006), Zsámboki (2006), Zsámboki (2007).

[5] Discretion is the right of decision, i.e. the party entitled to the right of decision (in the case of national discretion the Member State, and in the case of supervisory discretion the supervisory authority) can decide whether or not to apply the given regulation, or select from the possible decision alternatives the legal solution it wishes to apply.

[6] Currently putting the individual elements of regulation into decree form should be the desired aim; however, after more than a year of intensive negotiations, by November 2011 a stalemate had apparently taken hold. The agreement has not taken shape; fundamental conflicts exist among the interests and aims of the Member States, and not even the semblance of compromise can be detected in the vast majority of regulatory elements.

[7] When treating the concept of compensation, the Civil Code falls short with respect to the products of the financial sector, applying a substantially restricted concept of compensation.

[8] Note that in Hungary, the changes to regulatory capital requirements entered into force in 2008, parallel to the impacts of the economic and financial crisis. In addition, in a domestic context, the central burdens imposed on credit institutions

have modified the key figures of these institutions. Accordingly, with so many and such significant impacts, at present, it is only possibly to filter for the effects of the changes to the regulatory capital requirement by means of overly simplified models, which may lead to new and distorted results.

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