István Farkas

Supervision of the financial markets: Quo vadis domine?

The development of societies entails that the communities try to control and supervise larger groups, or simply activities that significantly influence the lives and status of a great number of people. Even this very general approach reflects the difference between the mitigation of actual damage, and activities aimed at the reduction of the risk of future damage. This difference is of special importance for the subject of this paper.

> *From this point of view, religious leaders and church organizations guarding commands containing meal requirements intend to pro-actively reduce the risks arising from non-compliance with the requirements, while actions taken after the outburst of epidemics – no matter how brutal they are – can only mitigate the damage. The activity of the fire watchers of mediaeval towns who called the population to "watch out for fire and water" was very similar to the current supervisory activity, therefore they shall not be confused with firemen.*

Naturally, development has entailed the establishment of plenty of supervisory institutions – ranging from epidemiology supervision to the nuclear energy agency – that monitor risks and try to prevent them from posing threats. However, institutions supervising the financial markets receive enhanced attention.

What explains this increased interest? In what do these risks differ from the other types of risks, and how should they be supervised? Do these general correlations hold true for the Hungarian financial sector, too? If we want to understand the challenges before the financial supervisory authorities, we must first of all understand the characteristic features of the market.

Modern financial markets are characterised by being unrestricted (unlimited) and general in nature, therefore they dynamically expand and closely follow technological advancements. We are often under the delusion that all this has been characteristic only for the last 50 years of our globalising world. It is true that we are just beginning to face the dramatic impacts. In order to prove that this is not a new phenomenon, let us recall a favourite novel we all read when we were young, *A. Dumas*'s The Count of Monte Christo. In the novel, Danglars bank went bankrupt because it undertook too much risk by purchasing Spanish bonds based on wire news. Of course we know that market disruption and insider information also played a role.

The Hungarian financial market is connected to the international economy and the international financial sector with a thousand threads. One of the (evident) reasons behind this is the international nature of financial activities. If we merely look at the clearing traffic, a small, open, foreign trade based economy, such as the Hungarian economy, cannot exist without the international relations of its financial institu-

tions. (This premise is justified if we look at the simplest correspondence banking connections.) The other feature – which is especially characteristic for the Hungarian financial sector, and very characteristic for the Eastern European financial markets – is the dominance of international professional investors in the ownership structure of the financial sector. The importance of foreign owners is indicated by the fact that at the end of June 2005 over 82% of the registered capital of the financial sector was directly owned by such owners. Together with the indirectly owned portion, the share owned by foreigners reached 89%.

The international embeddedness of the Hungarian financial sector received a new quality dimension after Hungary's accession to the EU. The specific concomitant of the internationalisation of financial services is the unification of the internal market of the European Union. There is now a free, administratively unrestricted flow of financial services between the EU member states. It must be admitted though that the ratio of services provided across internal borders is still relatively low. However, this ratio is expected to grow significantly due to the increased standardisation of European regulatory practices, the concentration of wholesale services in a decreasing number of financial centres, the rapid proliferation of electronic services, and the strong capital and service imports of the new member states. This trend is indicated by the fact that by the end of 2005 over 120 credit institutions with registered offices in the EEA member states,[1] over 180 investment companies and more than 250 insurance companies declared their intention to perform activities on the territory of Hungary, too. It is not surprising that much fewer market players with registered offices in Hungary (5 credit institutions, 7 insurance companies and 2 investment companies) declared their intention to provide cross-border services in the EEA member states. (However, it is extremely important that such institutions exist at all.)

This means that the Hungarian financial sector is no longer present on a market of 10 million only, and no longer competes only with those service providers that are registered in Hungary. Since May 1, 2004, we have all been the full members of a unifying financial market of 450 million, even if this is sometimes overlooked by the market players, regulators and supervisors. Due to the international correlations, interdependence and mutual determination of the financial markets – including the Hungarian financial sector – it is of fundamental importance to assess and analyse the key elements of the characteristic features of the financial sector and the elements of their changes.

THE CHARACTERISTIC FEATURES OF THE FINANCIAL MARKETS

Increased volume of financial intermediation

The elements of wealth intermediated by the system of financial institutions (e.g. bank deposits, capital market savings, insurance reserves, collective savings, etc.) are rapidly growing. This is due to the fact that one of the main consequences of economic growth is the continuous and high-speed augmentation of accumulated financial wealth, which broadens the possibilities of financial institutions. The number one contributor to the expansion of financial intermediation is the relatively high level of the gross savings ratio. The pace of expansion of intermediated capital is accelerated by – among other things – demographic changes and extended life expectancy, which entail the growth of collective investment schemes and insurance reserves. Financial wealth is growing faster – in the form of capital intermediated by financial service providers –

than is the total income of an economy. For example, in the period between 1991 and 2002 the GDP of OECD countries grew by 30%, while the volume of international trade increased significantly faster, by over 78%. However, the greatest expansion of nearly 133% was demonstrated by the financial savings of institutional investors. (Their assets more than doubled during the period under review!) According to the IMF report for 2003,[2] at the end of 2001 the total GDP of the world's countries was exceeded by the capitalisation of the money and capital markets (balance-sheet footing of the banks, share and bond markets, foreign exchange reserves) by nearly five times.

A shift between the intermediary channels

Due to the process of wealth accumulation and the extended life expectancy, investment type services (primarily the management of assets in funds and similar arrangements) have gained space at the expense of commercial banking services. Within the investment products the weight of securities has continued to grow due to their flexibility and increasing security. The growth of institutional investments at a rate exceeding that of the GDP and trade also indicates that financial activity is less and less performed through the banks, and more often directly, via the capital markets. This, of course, does not mean that classic financial intermediation, the deposit collecting and lending activity of the banks would decline, but the difference in the growth dynamics show a characteristic shift. Thus, for instance, according to the figures of the European Banking Federation, in the period between 1998 and 2003 the balance-sheet footing of the banks of the EU member states, the member states of the European Economic Area and Switzerland doubled (in euros, to 211.3%), while the growth rate of credits totalled "only" 88.7%. Apart from these general tendencies, Hungary may also find the example of Portugal (which joined the EU before Hungary) useful. The ratio of credit instruments in Portugal was nearly 90% in 1990, while the proportion of international and other investments did not even exceed 9%. Ten years later the ratios changed to 57% and 42%, respectively.

Technological progress

The incredible growth of intermediated capital made the entire financial system strongly dependent on the computer technology. In addition to the economy of scale, the extended nature of international connections, the need for the demolition of the boundaries of time and space, etc. have all called for the elimination of the speed, reliability and capacity restrictions of the data transmission systems. The customers and the expansion of the markets do not only require that the system should be able to handle several transactions at a *time*, but also that this real time could be practically any hour of the day.

The emergence of extremely high capacity new IT systems has had two other consequences. On one hand, the almost immeasurable speed of computations and the (practically) unlimited number of data to be handled have made very complicated risk management methods and techniques feasible. Risk management is based on probability calculation, the reliability of which is closely related to the number of elements processed. The probability of risks seems to be reduced in the increasingly sophisticated models compared to the former methods and by themselves, too, because the impacts of innumerable factors can be examined on a very large sample and at a very high speed. And this possibility allows for the creation of newer and newer products.

The other impact of technological advancement is that the new channels devised to take the products to their destinations are constantly changing. While the above-mentioned elements of IT development served operational, back-office tasks within the financial institutions, the electronic, mobile and remote data transmission tools will open up new possibilities in sales, too.

In the forthcoming years the most important technological achievement – as far as it can now be foreseen – may be the mass proliferation of broad band telephone and Internet connections. This would allow for the real time transmission of a large amount of data between different geographical locations, as well as for the widespread use of international financial transactions, even on a retail level. By 2005, the number of mobile phone subscribers exceeded 1.5 billion worldwide, which means that every fourth or fifth resident of the Globe has a mobile phone! As a result of similarly drastic growth, the number of Internet subscribers also exceeded 800 million. The numbers are fascinating by themselves, but the real challenge was the underlying dynamism: by the middle of 2004 the number of mobile phone and internet subscribers doubled compared to year 2000, i.e. within merely 3.5 years.

These telecommunication possibilities are integrated into the activity of credit institutions to an increasing rate and at a growing speed. (We already tend to forget that the widespread use of banking cards – and most account holders take the use of plastic money for granted all over the world – was basically the result of the development of telecommunications: no card system can exist without the possibility of massive data transfer!) A similar boom can be expected in the field of financial transactions via mobile phones and the Internet. (I deliberately *avoid using the terms Internet banking, bank card, mobile bank, etc.* With this I would like to point out that these data transmission tools can be and are more and more often used in the case of any financial product, e.g. in the banking, investment or insurance fields. This means that their impact is not confined to the banking sector.)

The combination of products and services

Accelerated decision-making, expanded space and time – in relation to the enormous sizes – have strengthened risk awareness, and consequently, the need for risk sharing and transfer. This has significantly encouraged product development, the dismantling of products to elementary particles and the selling thereof in new risk packages. There is a large number of newly available products based on the sharing, separation, transfer or assumption of the risks varying in type and size, and it can be taken for granted that several new schemes will appear. The number of available financial products is substantially increased by to the process of internationalisation, too. An almost unlimited range of financial products can be generated on the basis of the investment opportunities created by the various national currencies, the markets of bonds and shares, yield curves etc.

This is why it is not surprising that the sale of derivative products used for hedging risks and for speculative purposes grows faster than the sale of financial services on average. Apart from the classic derivative products, the inclusion of the different types of risks “in one package” has already crossed the classic sectoral boundaries. The merger of bank guarantees and the traditional insurance products can be regarded almost as a classic example, but the collective sale of capital market (investment), well as bank and credit market products is on the rise, too.

The combinations of financial and non-financial products are more and more widely used, such as fidelity retail cards offering

favourable conditions for buying products and services, or credit facilities combined with retail discount campaigns. What is more, financial service providers are increasingly involved in supplementary, non-financial activities such as lending banks having titles of ownership of real estates registered at land registry offices or health services organised by life insurers, etc. At the same time, non financial institutions also render financial type services, such as such as the issuance of certain cash substitutes (e.g. telephone and fidelity cards etc.).

Institutional restructuring

All these factors have significantly influenced and will significantly influence the institutional structure of the financial market, too. One of the main orientations in the development of financial services is an increasing institutional concentration, driven by the over-supply of services in the market and by diminishing profitability. However, large volumes require an extensive operational technique, which can be cost-efficiently utilized only in case of large traffic. If the growth of size occurred only at one or two companies, the oversupply would reduce revenues to the impossible. The response to this challenge is comprehensive and general concentration according to previous experience, and fusion according to the service providers. In the past years we could witness extensive bank mergers such as the merger of Bankers Trust and JP Morgan in the United States, or the merger of large residential banks, i.e. that of NationsBank and First Union. In Europe, where there is a relatively significant capital crunch, this process started earlier, at the beginning of the 1990s: for instance at ING Bank, which was established upon the merger of the Dutch Postbank and NMB Bank, or later the merger of the Greek Alpha Bank and the National Bank of Greece, just to mention a transaction carried out in a country that is closer to Hungary in terms of development.

The engine of these bank mergers was the above mentioned requirement of reaching an economy of scale. However, in the case of some mergers – for instance the mergers of residential banks – the really important factor was the alleviation of the supplementary nature of the branch units, or the reduction of IT development costs. However, there is no doubt that mergers in the commercial banking sector have been primarily and generally carried out for the sake of reaching an economy of scale and/or to reduce development costs.

This process is fostered and accelerated by liberalisation and the international harmonisation of regulation. In the past 10 years a major transformation of the system of financial institutions has started e.g. due to the fact that the Supreme Court of the United States did not bar the fusion of the Citibank and Travelers' groups. As a result, the merger occurred not simply between two commercial banks, but between a commercial bank and a financial group engaged also in the insurance and the security businesses. As a result, opportunities in the US opened up for what the above-mentioned ING group commenced in Europe: a multifunctional financial group was created by the fusion of a bank and an insurance company. (The term bancassurance service was introduced specifically for this couple, the “marriage” between a bank and an insurance company”.)

However, institutional consolidation does not necessarily trigger a drop in the number of institutions. It rather means increased capital and management concentration. Therefore, we have all rights to assume that the lead actors of institutional development to be realized in the coming years will be large financial groups involving a number of institutions.

Finally it can be concluded that the products and institutions of the financial market can be less and less linked to individual sectors, and

that the boundaries between them have become and will become increasingly blurred. This process has required the increased integration of the supervisory authorities, and it has necessarily extended to areas that are located at or beyond the boundaries of the classic areas of supervision, since non registered institutions can have a major or adverse impact on the supervised financial markets, irrespective of their legal status.

The international interlacement of services

The emergence of groups also indicates that in addition to the classic corporate models the role of new and alternative solutions has increased on the financial markets, too (e.g. management cooperation instead of capital fusion).

The mass production of international financial services first of all required real time connections, an international IT and telecommunication system capable of handling a large data traffic and capable of unlimited connections, as well as globally harmonised (compatible) national regulations and standardised institutions that allow for the cross-border flow of persons, information, income and revenue. Said technological tools and the institutional conditions of regulation have undergone rapid development, wherefore substantial technological and institutional integration has occurred globally.

A special concomitant of this process is that as a result of the European aims for integration the multiplication of branch units, the provision of cross-border services and the establishment of European share companies seem to be a process with a considerable proliferation potential. Technological development makes it possible to conclude deals without being physically present, and the intention of the regulators to establish a single financial market in the European Union also calls for such activity.

For the time being it also seems sure that the interregional centres (primarily London, New York, Hong Kong and Tokyo) will preserve their significance despite the fact that major steps will be taken for geographical diversification as a result of the development of the IT technology. For this reason, the national and regional financial centres, as well as the concentrated institutionalised markets that serve as a core of the activities of such centres, the money capital and the commercial exchanges will continue to play a significant role. The “wholesale” and “retail” trade of financial services will be increasingly carried out in the centres and at local levels, respectively.

DO THESE STATEMENTS ALSO HOLD TRUE FOR THE HUNGARIAN FINANCIAL MARKET?

Due to the size of the Hungarian market and the nature of financial intermediation it cannot be argued that the Hungarian market is fundamentally influenced by the changes in the characteristic features of international financial intermediation. This can be supported by logical correlations, as well as facts.

As far as the size is concerned: the ratio of Hungarian financial intermediation – although it considerably falls short of the international level equalling a multiple of the GDP – has significantly increased in the past few years. The volume of the Hungarian financial sector will most probably grow very rapidly, at a rate exceeding the annual nominal GDP growth by 5 to 10%, on a path designed to catch up with more developed countries. As a result, the size of the intermediated capital may double in five years (measured at current prices), or may more than quadruple in ten years. As a straight-

forward concomitant, the so called penetration rate (calculated with the IFM's method) may grow from 156% at the end of 2003 to 310 to 330% in a decade.[3]

Let us now look whether there is any sign of a *shift of gravity between the mediation channels* in Hungary. This question is all the more exciting, since in the past years the "credit hunger" of Hungarian consumers has rapidly grown, and there is much talk about the fact that the Hungarian population demonstrates weak saving performance. The fact that the Hungarian population has invested a significant portion of their savings in real property (real estate, flat, etc.) – which is almost unique by international standards – can be explained with historic processes. (If we accept that, the structure of residential savings typically changed according to the international trends after the year of change: collective savings (pension fund assets, investment funds, insurance reserves, i.e. collectively: institutional savings) have risen much more rapidly than deposits. As a result, the ratio of residential savings to Forint deposits grew to 70 to 75% in 2004, and exceeded 90% by mid 2005. Naturally, this shift in proportions can only be interpreted with extreme prudence in the short run, since the value of the investment market can quickly change, therefore only the trends of longer terms can be regarded as standard. However, based on the data of the Association of Investment Fund and Asset Management Companies in Hungary (BAMOSZ) it can be stated that the ratio of all institutional savings to all deposits – residential deposits, Forint savings and classic bank deposits, as well as the amount of repo transactions – was around 37% at the beginning of 2002, but exceeded 50% by mid 2005 – with smaller or larger fluctuations.

Similar trends are indicated by the data series of the National Bank of Hungary, too. In the past ten years the indebtedness of the Hungarian population has drastically increased; the volume of credits has grown by over eleven times. Within the population's net financial wealth the ratio of deposits dropped from nearly 50% to 43% between 1995 and 2005. The picture is even clearer if we look at the gross savings (i.e. the financial assets only) of the past ten years: the 42% deposit ratio of 1995 fell to 31% by the end of 2004. Thus, we may risk saying that the shift in the point of gravity of the financial intermediary channels – typical for international markets – can be observed in Hungary, too.

In terms of *technological advancement* relevant for the development of the financial market, the Hungarian market can be characterized with processes identical with the international trends. The number of mobile phone subscriptions has grown from 1.6 million to 9.3 million in the past five years[5], while the number of personal computers in household use has increased from 1.1 million to 3.3 million. In 2002, only one per cent of the computers had live Internet connection. By early 2005 this ratio grew to 14%, and within the same period the number of Internet subscriptions also increased significantly, from 320 thousand to 741 thousand. All these figures indicate that technological development in Hungary keeps pace with – or in certain segments exceeds (e.g. popularity of mobile phones) – the average international trends.

It is worth noting that in Hungary it is actually on the financial markets where one can observe a specific feature of countries striving to catch up with their more developed counterparts, i.e. that such countries skip those stages of development that are regarded as dead-ends. A classic example is skipping payment by check, i.e. the transition from payment by cash to the use of plastic cards. A similar example could be the shortening or skipping of the transitional phase from Hungary's underdeveloped wire telephone network to the widespread use of mobile phones.

The *combination of products* is also an everyday experience in Hungary. The combination of investment coupons and deposits has been a typical example of the past years. The wide range of examples also includes the payment of parking fees via mobile phones, the appearance of fidelity cards issued by the different department store chains, the combination of insurance and credit products.

Naturally, product combination is not separate from the *institutional concentration,* which is typical for the Hungarian market, too. From this aspect the data are rather assuring. At the end of last year over 80 per cent of the market was dominated by 20 groups of financial institutions. On average, over ten financial institutions belonged to each group, wherefore a total of 224 institutions were affected. (Naturally, these institutions included banks, investment service providers, insurance companies, pension funds, leasing companies, factoring companies, etc.) The list can be continued with the Hungarian agreement between ABN Amro and the Belgian KBC, the acquisition of Postabank by Erste Bank, up to Allianz Insurance Company's current intention to establish a bank. However, these figures and facts represent only such events that are initiated in Hungary or that concentrate on the Hungarian market. However, we are well aware of the fact that due to the *international embeddedness,* Hungary is also influenced by fusions of regional importance such as the merger of HVB and Bank Austria, which later extended to Unicredito, too.

SUPERVISORY CHALLENGES

It can be laid down without a doubt: significant changes have occurred on the financial markets of the world in terms of size, products, technology, institutions and international cooperation. Therefore, it does not take much courage to say that all these processes are typical for the Hungarian market, too.

The financial supervisory authorities must keep an eye on the transforming market everywhere. This is why it is necessary to review what these changes mean for supervisory tasks and for the responsibility of risk management in general. Every supervisory authority – and naturally every financial authority, including the Hungarian one – sets its tasks so that they would foster the transparent, reliable, socially acceptable and safe operation of the area (part of the market or the market) assigned to it. This is reflected in the duties of the Hungarian Financial Supervisory Authority, too that were revised in 2005.

"… as a member of the supervisory community of the European Union and in an integrating financial market, the Supervision shall:

- ensure reliable, continuous and transparent operation of the financial markets;
- strengthen confidence in the financial markets;
- promote the development of financial markets based on fair competition;
- protect the legitimate interests of market participants;
- support the reduction of consumers' risks by providing access to adequate information;
- actively participate in eliminating financial crime."

It goes without saying that this is not a static task description; this is why the adjective "integrating" – meaning a process – is used already in the introductory phrase. Therefore, in the future the tasks of the supervisory authority can be surely and exclusively determined on the basis of the market changes. From this aspect it is worth asking what the difference is between the *supervision* and *control* of financial institutions. Control is a static concept, because it always compares a situation that has evolved against a (formerly fixed) set of requirements.

(This holds true for the authorization activities of the controlling organizations too, since they compare the written facts to previously formulated requirements.) The length of control can of course vary significantly, it may stretch from the formal requirement of legal requisites to the inspection of the regularity of concrete contracts.

On the other hand, supervision is a more dynamic concept. Its subject is the *future* instead of the *past*, or the *possible* instead of the *present*. As a result, the fundamental task of supervisory authorities (including the Hungarian authority) is to assess and manage the risks of the future by responding to the real processes. From this perspective it is especially worth examining what tasks the Hungarian supervisory authority faces as a result of the market processes described in the above sections. (Let us now focus on Hungary only.)

The growth of intermediated capital entails that on one hand the mass of assets guarded by financial supervisory authorities are greatly increasing, i.e. the stakes, the responsibilities of supervisory authorities are growing. Secondly, the income coverage of financial liabilities decreases, and the risk of lending (intermediation) increases in general. Thirdly, due to the growing number of chain-like connections between the financial markets and institutions, there is a growing systemic risk of non-performance of liabilities and of all other kinds of operational disorders. This means that due to the size of the financial wealth both the risk of individual lending transactions and the systemic risk of accumulated disorders are growing.

Rapid development complicates adjustment to the new technological conditions, and the speed of change makes it more difficult to identify new risks and to introduce procedures that are suitable for the elimination of such risks. Disorders of the IT and telecommunication systems, as well as new types of criminal acts (money laundering through electronic means, Internet fraud, data theft and terrorism) also have to be taken into to a greater extent. In addition, the expansion of the available information and the range of possible courses of action are, in some cases, prompting financial decision-makers to assume new, greater risks.

The expansion of the product range, as well as the various combination of products, services and service providers are increasing the information gaps between service providers and customers (information imbalance), eroding the transparency of the market, which makes it difficult to raise risk awareness. The increased concentration of capital and management, the geographical concentration of certain financial transactions make risk distribution and sharing, and the analysis thereof complicated. This enhances the need for a more thorough analysis and more efficient management of the correlations.

In the forthcoming years – due to the rapid development of technological and institutional conditions, as well as the still strong driving forces behind globalisation – one can expect an exponential growth in international financial activities. And this requires the reinforcement of the international activities of supervisory authorities working within national frameworks.

These phenomena themselves represent new threats and serious tasks for the supervisory authority. In addition, one must take into account that in May 2004 Hungary became part of a unified (unifying) market. Therefore, we must harmonise the rules and standards, since different regulations would make a dent in the competitiveness of the European market. This is why we can realistically count with the gradual elimination of regulatory differences. In the long run a standard community regulation can be expected in the European financial sector, and in line with this, we can expect the development of a supervisory network based on uniform standards.

RESPONSES OF THE HUNGARIAN FINANCIAL SUPERVISORY AUTHORITY

Transformation of the management structure

The first question that we need to ask ourselves is whether it is possible at all to complete these new tasks in the current Hungarian or classic public administration management structure? Is it possible that task-setting adjusted to the changing environment, the implementation of the concrete actions of the authorities, the comprehensive evaluation thereof, etc. be concentrated in one hand?

The answer is quite evident: no. In the controlling organisations one level management does not necessarily pose a problem, since the task is to meet the set rules. However, if we need to and want to give efficient (adequate) answers in a constantly changing environment, we need to have a two-level management system: on one hand we need a level that sets the strategies and the requirements, and performs the evaluation, on the other we need a separate level that manages implementation.

> *Although the management system in effect at the Hungarian Financial Supervisory Authority since May 2004 is novel in the Hungarian public administration system (with the exception of the Communications Supervisory Authority, perhaps), most financial supervisory authorities of the world already operate in this two-level system.*

However, the classic internal division of the management system (between the directorate and the management) now used worldwide due to the needs of our time, cannot only enhance the efficiency of operation. It is equally important that two further basic requirements are becoming stronger: independence and accountability.

The supervisory authorities – including, naturally, the Hungarian Supervision – are funded by a community so that major financial market problems could be avoided. (Funding is independent of the method of financing, since this is a community service that is ultimately always paid by the society.) If accounts of task performance were given at the level of implementation, and of each action carried out by the authority, the Supervision would practically be paralysed. Or all new challenges and changes would be (totally) banned – which would hinder development (as several Hungarian examples show) – or the responsibility for the decisions would be typically passed on to others.

The establishment of the new level of strategic development, i.e. that of the supervisory board, created the possibility for the clear separation of responsibilities. Supervisory tasks became accountable in a manner that during the evaluation of concrete supervisory decisions, actions, etc. only the concrete facts can play a role. In the concrete cases decision-making and evaluation are carried out by different people. This makes it possible that in addition to the independence from the other authorities, as stipulated by the law, independence from the market (from the market players) can be ensured, too. And this is the often cited supervisory independence. This is the most important factor, since real independence can only be created with professional expertise and competent and substantive behaviour. The fact that the market and the public administration institutions are linked to the Supervisory Office not directly, or not primarily, but only through the Supervisory Board, did strengthen this independence based on professional competence and responsibility. The separation of the strategic and implementation levels naturally made it necessary and unavoidable that the Supervision – and both levels thereof – should be transparent for the decision-makers, the market and the general public alike. This

requires that the decisions, reports, etc. should always be given real and not only formal publicity.

Establishment of a really integrated supervision

The advancement of integrated supervisory authorities was triggered by the size of the market and the diversity of products. The increased integration of the markets and the service providers, the general concentration of the capital and management require the strengthening of similar processes now and in the future, too.

Due to the interdependence of the market processes, the financial supervisory authorities increasingly aim at closer cooperation among themselves. Although they represent a major step forward, many of these solutions remain at the level of consolidation of formerly separate supervisory authorities.

The Hungarian supervisory authority was one of the authorities that embarked on this road. The supervisions were channelled in this direction – i.e. towards a system operating under a single "umbrella organisation" – already by the operation of Hungary's universal banks, in which capital market products and credit products are offered by one institution. Although governmental intentions have always exceeded the formal integration of the supervisory authorities, it was this transformation of the management that made it possible to move one step higher on the ladder of integration.

According to the traditional supervisory – or, more precisely, auditing – concept, the scope of the supervisory authority focuses on the individual players of the regulated market (authorization of entry into the market, ensuring compliance with the rules in each institution, etc.). However, the appearance of universal banks in Hungary and then the changes arising from the emergence of market groups made it clear that this approach (institution specific authorization and controlling methods) cannot be maintained any more. (What is more, the group supervisory authority does not only inspect the regularity of the supervised institution, but also that of organizations that may influence such institutions, even though they are not under the jurisdiction of said supervisory authority.)

A consolidated supervisory authority becomes really integrated if the supervisory aspects and methods, as well as the principles and methods behind the approaches become similar. This requires that the supervisory authorities should find the elementary particle that is common in all activities carried out by the different financial institutions, and which could be directly compared already in the first round, irrespective of the category to which the institution or the product belongs to. This common elementary particle is risk.

The fundamental obligation of the participants of the financial intermediary system, i.e. that they must be able to timely and fully pay their liabilities, is becoming an especially complex task in the case of integrated activities – due to the increased sizes, the combination of products and service providers, the increased significance of the groups and the transferability of certain risks. For example, the risk of a financial group is not necessarily equal to the sum of the risks borne by the group members. A customer's risk may be relatively low in one of the group members, but if the same customer is linked to all other group members, this could pose a significant risk. These connections can only be realised and handled by a really integrated supervisory authority.

Technical progress further increases the significance of operational risks: i.e. there should be no such event or situation in which something – even a technical problem – would hinder the financial service providers from meeting their obligations. Personal risks also belong

to this series of logic: the size and complexity of financial intermediation does not grow by themselves; the responsibility of each employee grows, too. This means that the flawless operation of the management and the internal control system is a key issue because of the personal risks, too.

These risks no longer belong spectacularly to a specific product or institution. However, the status of each service provider or service can be rebuilt from the elementary risks. And this is the essence of integrated supervision: each institution or activity is first dismantled into elementary risks, and then reassembled with newer and newer methods. The former, one-sided institution centeredness is also questioned by the fact that in many cases financial innovations appear in non financial institutions. However, if the supervisory authority is responsible for the safe operation of the entire financial market, it must be able to recognise and handle these external phenomena in time.

The market of financial services is purposefully strictly regulated: it is evident that supervised institutions (those subject to authorisation) must be evidently in the focus of supervisory activities. However, the real market is a broader category: it includes the consumers, the customers in general, those who collect funds directly on the capital market (issuers) and market institutions such as stock markets or clearing houses. The fair and transparent cooperation of all these actors provides the background with which a relatively developed financial market can function and further develop.

However, it cannot be denied that there are actors that "influence" the financial market by providing financial services without a permit. The early discovery and harsh punishment of unauthorised (often illegal) activities naturally do not mean that the supervisory authority would make such activities legal with this extension. However, the security of legal market players requires that the supervisory authorities should focus attention on this illegal segment, too, since these "disrupters" cause unfair competition and disturbances for financial institutions that operate with a permit.

The market practice according to which the products and institutions can be less and less linked to the different sectors, and that the boundaries between them are becoming increasingly blurred, required the reinforcement of the so called market conduct activities of the supervisory authorities. Necessarily, this had to be extended to areas located at the boundary or beyond the boundaries of the classic categories under supervision, which can significantly influence the financial markets irrespective of their legal status. The stable, transparent and prudent operation thereof has always been the responsibility of the financial supervisory authority.

Organisational restructuring

The difference between the really integrated or simply consolidated supervisory authorities obviously manifests in the organisational structures, too. The new supervisory organisation replacing the former organisational frameworks – which were designed the meet the controlling and right enforcement tasks tied to the different sectors – fundamentally reflects that the intermediary activities of the players of the financial markets is shifting. Furthermore it reflects that the registered financial institutions and other non financial market factors may equally influence the operation of the markets. This is why the Hungarian supervisory authority developed already in 2004 the new organisational structure based on two pillars, where the *market surveillance* function has been elevated to the same rank as that of the traditionally prudential *institution supervision.*

Another major organisational concomitant of integrated supervision is that due to the com-

bination of the market processes, the traditional structure of super- and subordination is becoming less and less efficient. The role of horizontal cooperation is increasing since similar risks must be handled in a similar manner. This requires a matrix type organisational structure: within the supervisory authority in compliance with the activities and institutions, and partly in compliance with the various financial and operational, market, etc. requirements. This is the other major supervisory trend which can already be observed in the work of HFSA. This goal is served by, among other things, the establishment of permanent professional committees within the Supervision, as well as by the projects launched for the solution of major issues.

The basic concept of integrated supervision, which is based on the collective and comprehensive realisation of the combinations of elementary risks, and the related organisational solutions make it necessary to create the conditions for risk based supervision as soon as possible. Realisation of the risks requires well-considered, organised and thorough analysis, which also necessitates the existence of high level expertise. At the same time however, the fact that the supervisory authority uses the resources of the community – i.e. its possibilities are far from being indefinite – made it inevitable to quantify not only the probability of the risks, but also the impacts and consequences thereof. This means that today we must give up the automatic and mechanical application of the classic reference books on supervision in methodological questions, too. Instead, the focus must be shifted to ongoing supervision.

Finally, we must discuss another organisational element representing the increased social responsibility of integrated supervisory authorities. This element led to the establishment of the controlling department (which ensures the accountability of the supervision, i.e. systematically monitors the use of resources) and the creation of the independence of efficient internal controlling. Both organisational elements can operate efficiently only where the two-level management provides the environment in which these organisational units may perform their tasks smoothly and fully, i.e. unrestricted by the day-to-day operation.

Creation of a new supervisory concept

The risks arising from the emergence of increasingly complex products, the combination of service providers and services require changing regulations and more complex supervisory procedures. The latter could be developed based on the revolution in IT solutions, which allowed for the more detailed and precise description, assessment and modelling of the products and the risks they carry. The main examples for this are the new capital agreements (Basel II and Solvency II) which were concluded in the banking and the insurance sectors, and the details, the prospective application and operation of which will radically transform the work of financial supervisory authorities during the forthcoming years.

The essence of the new approach can be best described by the term "ongoing and substantive supervision". As the market processes become more and more complicated, the evaluation of individual money, capital or insurance market phenomena becomes impossible and also insufficient. Naturally, ensuring the legal operation of the institutions remains an important task, however this in itself is surely not sufficient any more. The first element of *ongoing substantive* supervision can be thus characterised by the fact that while all available information is gathered, the real task is the ongoing analysis, evaluation of such information including the exploration of the correlations, the regrouping of such information according to the new aspects, and the systemic re-evaluation

thereof. This is what we call a *360 degree approach:* we must be able to understand and judge all phenomena of the financial institutions from every aspect. The second element of ongoing and substantive supervision is that the collection and evaluation of the large volume of information make it possible to use supervisory resources in a more rational way, since the size of the different risks and their respective negative impact on the market can be assessed collectively.

In this approach a new and important element is the considerable growth of the responsibility of the staff of the supervisory authority. The "supervisor of the institution" must be able to decide whether a phenomenon related to a certain institution requires further analysis, or maybe the launch of an investigation – and if yes, what kind of and how thorough this analysis should be. This increased responsibility can only be assumed (borne) if a new approach evolves in addition to the above-mentioned modifications in organisational management. Instead of auditors looking for flaws, the mentality of supervisors who want to and are able to mitigate the possible risks of the financial institutions in a proactive manner shall become prevailing.

As part of this new approach, non-mandatory elements of market influence will also strengthen. The rapid market changes make it nearly impossible for legislators to respond with the required high level rules of law. It is often doubted whether it is justified to respond to the new phenomena immediately with rigid rules. It must be understood that – even if the development of new rules of law is justified – the preparation and approval thereof is usually a long and tedious process, and the market has all rights to expect some orientation during this transitional period. The supervisory recommendations are designed to resolve this contradiction. The recommendations are not mandatory, but they contribute to the transparency of the market. So that the level of acceptance of a non-mandatory rule would be high, and that the professional standards of communication between the market players and the supervisory authority would be well-founded, in 2005 HFSA introduced a consultation mechanism via the Internet (which had already proved to be working in the EU practice). Compared to the traditional short conciliatory talks, this seems to be a procedural system capable of exploring the broader, professional and content related correlations and details.

There is no doubt that the safe operation of the financial market has been and will be the responsibility of the financial supervisory authorities in the first place. However, we must know that we can rely on many allies in performing this task. On one hand, there is no doubt that the overwhelming majority of the market players also have an interest in having no market disruptions, since such disruptions make the conditions of the competition unrealistic, and hinder the expansion of the activity and naturally that of income generation. On the other hand, especially based *on the concept of substantive supervision,* the controlling and influencing functions and actual activities of other authorities and institutions could assist the financial supervisory authority in completing its tasks. As a result, the better utilisation of the often cited cooperation needs and intentions is the fundamental interest of all of us.

In the current practice of the Hungarian supervisory authority regular meetings are held with the professional associations of the different sectors for this purpose, too. Meetings provide an opportunity for the supervisory authority to get acquainted with the new phenomena of the financial markets more rapidly and thoroughly. Furthermore, meetings offer a platform for launching free discussions between the market players and the supervisory authority about the conditions for the undisrupted operation of the market. However,

apart from the market players, the supervisory authority maintains regular connections with all organisations that have a certain obligation in relation to the transparency of market processes and the safe operation of the financial institutions, or at least are interested in that. So for example, auditors and internal controllers are actually the allies of the supervisory authority, since their representatives are the first ones to meet the risks at the earliest time during their daily tasks. The importance of this cooperation, or more precisely, the consequences of not taking the necessary steps were well demonstrated by the infamous Enron and then Parmalat cases, in which significant damage was sustained – partially – because the "first filter" did not move properly, to put it mildly.

The third group of HFSA's allies is made up of all those authorities and organisations that are not authority affiliated that have their own control profile, and may greatly contribute to the work of the prudential supervisory authority by analysing the activities of the same market players from a different perspective. Such organisations include the Hungarian State Audit Office, the Economic Competition Office, the State Tax Authority, the Customs and Excise Office, and the Governmental Control Office. These institutions may draw attention to the new market trend through their respective cooperation agreements, with regular consultations. (Obviously, the protection of individual data is of utmost importance. However, the knowledge of the typical and common tax avoidance techniques may be helpful in the development of methods for the investigation of money laundering, and anomalies found at the financial institutions may also be thought provoking for other fields.)

For the regular operation of the system of financial institutions, and similarly to the majority of the EU member states, there is a so called tripartite stability agreement in force in Hungary, too, among the Ministry of Finance, the central bank and the supervisory authority. This special agreement was brought about by the common responsibility assumed for the balanced operation of the financial system, and the diverse tasks. The Ministry of Finance, which is responsible for the budget and for regulation in general, the National Bank of Hungary, which is responsible for the monetary policy, and HFSA, which supervises the transparent and reliable operation of the financial markets regularly review the status of the entire financial system and the necessary tasks.

Integration into the European supervisory network

The supervisory responses to the market challenges have so far mostly focused on the issues of internal integration. At the same time, however, one of the major elements of integration is the European integration of financial markets – and as a result, the supervision thereof. Therefore, the requirements of the unifying European market have been unduly neglected for a long time. However, the globalisation of the economy and the resulting globalisation of the financial shed a new light on the international integration of the supervisory authorities. The traditional cooperation, experience and information exchange between the supervisory authorities, which was fundamentally based on bilateral ties, was only the first step, because these relationships centred around the individual financial institutions. (When the owner of a financial institution of a country owned a financial institution in another country, but those were run in compliance with separate, independent regulations, more extensive supervisory relationship was not really needed.)

However, since the boundaries between the products and the institutions have become blurred, and the elementary risks may appear in any other European country at the discretion

of the financial institutions, the supervisory authorities must face a new situation. And this means that without actual, really comprehensive cooperation no European supervisory authority can be sure that it can fulfil its main function: to ensure the smooth and transparent operation of the markets. Within this process, the versatile cooperation of the EU member states, as well as the harmonisation and standardisation of the regulation and supervision of the financial sector are becoming more and more intense.

Of the *principles of freedom* of the European Union (the free flow of capital, goods, services and labour) especially two, the free flow of capital and services influence considerably the market of financial services, and naturally the supervision thereof. As a result, it is an inevitable desire to have an internal market in legal terms, too, and thus to reduce the national separation of the financial service providers and usually that of financial activities. And if the financial markets are unified, the regulation and supervision thereof must follow the same direction.

The free flow of services and the harmonisation of the rules created the possibility that the single European financial market can be entered from any member state. This fact is important from two aspects. On one hand, each supervisory authority will have increased responsibility. If service providers supervised by a certain country cross the border, they take the responsibility of their supervisory authority with them. Their original, home supervisory authority will become responsible for the reliable and fair operation of an institution (service provider or product) on a market of 400 million people. The other side of this issue is the trust between the countries and the inspectorates. Namely, since the host countries must accept the decision of the supervisory authorities of other countries, the countries need to build trust in one another. One token for this can be the so called *Lámfalussy-process*, which provides a framework for cooperation among the supervisory authorities. The fact that in addition to the political forums that make the most serious decisions (European Parliament, EU committees, etc.) the EU member states established the so called third level, independent supervisory committees indicates how serious the EU is about creating a single financial market.

Supervisory cooperation, mutually accepted recommendations, the standard interpretation of rules, etc. are – for the time being – aimed at the harmonisation of the supervisory boards of the parent company and its subsidiaries (home host supervisory authorities). This is especially important for the Basel II and Solvency II processes, since in these processes the aim is the mutual acceptance of the methods and models applied or to be applied by the institutions. From the aspect of ownership logic it is evident that the parent institution sets the rules. The problem with this is that in many cases the subsidiary operates in another environment and under the jurisdiction of another supervisory authority. In today's Europe this so called home-host problem seems to be very serious, wherefore a significant part of the discussions is aimed at the resolution of this problem.

This means that the above-mentioned phenomena also require the enhanced international integration of supervision. The EU legislations (the directives) are introduced through the internal legislative acts of the individual countries. However, for the time being, standard interpretation is ensured and served only by the cooperation network of the supervisory authorities. It is not yet clear at what pace this cooperation between the supervisory authorities will change, and will make way for a more coordinated, European supervisory concept. However, as long as the internal borders remain in place – and real cross-border activity remains modest partly due to this fact –, this

type of supervisory cooperation network based on trust will work, albeit with more or less hitches and more or less tensions. However, there is no doubt that if the actual flow of services will pick up, the need for the operability of the market, and the supervisory authorities' responsibility to ensure such markets will force the establishment of a (more) standard supervisory system, in addition to the further strengthening of trust.

The strengthening of consumer protection

The expansion of the financial markets and the increasingly complicated product schemes have widened the information gap that has always existed between the professional service providers and the lay consumers. In the new logic of supervision the reinforcement of consumer protection is based on the fact that the tension between the financial service providers (the supply side) and the consumers (demand side) – primarily retail customers and not the institutional consumers – is primarily attributed to the inequality of information available to them. Consumers have had little information about the increasingly complicated products and the inherent risks even before. On one hand, this relative ignorance may temporarily increase the marketability of these products. On the other, this significantly increases the risk of the entire financial system, since the concentrated outbreak of unrealised, yet massively undertaken risks may jeopardise the service providers, too. The consumer protection activity of HFSA – partly as a result of the aforesaid – is of course not primarily aimed at remedying the complaints of individual consumers. Instead, HFSA regards such complaints as important and general information affecting system risks, too. Therefore, complaints lodged against several institutions require a general need or requirement for information, maybe immediate market protection measures. On the other hand, institution specific complaints provide fundamental information that may later influence security for those *in charge of the given institutions*.

THE PRESENT

If it is more or less clear and acceptable which way the global financial markets are heading, and it is also evident that these directions are typical for the Hungarian market, too, it is worth asking ourselves the following question: how far have we got in the development of the new, *integrated, ongoing, substantive and proactive supervision*?

The market processes described in the first section made it necessary, while the restructuring of the management system outlined above (to separate the Supervisory Board and the Office) made it possible for the Supervision to develop its strategy up to 2010. After long and thorough debates the Supervisory Board determined eight new lines of action in the new strategy of HFSA. Several of these lines of action have already been discussed:

- ongoing and substantive supervision,
- the analysis of professional contexts,
- reinforcement of the international character of the supervisory authority,
- the need for implementing EU regulations,
- the requirement of active market influence,
- the elevation of prudential supervision and market surveillance to the same rank,
- the efficiency of the use of resources.

The *most comprehensive line of action,* which is probably the most characteristic feature of the new strategy, is clearly the enhancement of the responsiveness of the supervisory authority. If the financial world around us is in constant change, we must establish a supervisory author-

ity that is able to fulfil its function in such a world. This means that the ability to respond to the changes quickly and firmly must be developed and enhanced in each employee of the supervisory authority. We must make ourselves and our environment understand that something that was good before is not necessarily good today, and the sustained application thereof under the new conditions may not be effective any longer. From this perspective, the most general formulation of the strategy shall govern: "By elaborating the strategy of 'Efficient Supervision' we aim to prepare the supervisory authority prepared for the foreseeable changes and to ensure that the Supervision has the capacity to respond to unexpected changes."

It may seem contradictory, but to the question in the title we must answer that the implementation of the strategy started with the preparation of the strategy. Already the formulation of the strategy required us to systematically review where global finances are heading, and where the Hungarian market is heading? We also had (have) to regularly assess the strengths ad weaknesses of the current supervisory authority in a (self-)critical manner, and must determine whether the former and current organisational forms or structures suit the new tasks outlined above. By being able to define these principles we actually set the most important direction of implementation.

Apart from the formulation of the strategy, the most spectacular result was achieved by starting the unification of the act pertaining to the procedures of the supervisory authority. With this we do not want underscore a range of other, equally significant initiatives, such as the commencement of the consultation mechanism or the work of the supervisory committees. Since the act on HFSA amended in the autumn of 2005 – and which entered into force concurrently with Act CXL of 2004 on the rules of public administration procedures and services – implemented the first stage of the unification of the former, sectorally fractured procedural rules, and thus the development of integrated supervision in the framework of laws, we are continuing this path. And we can already see the next stage, which can be the enaction of the Act on the payment of standard, risk based supervisory fee – hopefully already in 2006.

NOTES

[1] European Economic Area, member states of the European Union, as well as Iceland, Norway and Lichtenstein

[2] Global Financial Stability Report (IMF, Washington D. C., March 2003)

[3] István Rácz: Long-term forecast about the expected changes in the international and national macroeconomic processes, the development of the global money and capital markets and the requirements set for the system of financial institutions and the financial supervisory authority. HFSA workshop studies, manuscript, January 2006, page 3

[4] quarterly reports of BAMOSZ

[5] National Communications Office, quarterly reports