

## **INSTITUTIONAL CHANGES OF FINANCIAL SUPERVISION IN HUNGARY**

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### INTRODUCTION

My thesis deals with the institutional changes of the financial supervisory system. According to this, first of all, I try to answer an important question „Why the supervision of the financial market is justified?“, then I examine the impact of the international and EU rules into the national legislation and the Hungarian institutional changes in the supervisory structure are described.

### CERTAIN FACTORS OF THE REASONS OF THE SUPERVISORY FUNCTION

Why the supervision of the financial market is justified?

Like any business organization, the capital market participants are oriented by profit. Money itself contributes to economic growth, affects the maintaining of stability, and it is important to have the trust from the both sides of participants' activity. However, due to liquidity problems temporary or permanent problems may arise at the capital market operators, which can lead to problem at the case of a capital market participants with bigger influence. In this case, the supervision is necessary to ensure risk exposure of the participant is not compromise the stability.

Trust is especially important for the customers, because of it the financial consumer protection also receives great emphasis in the operation of supervision. In any case it can be assumed that the proportion of the information among the participants occurs differently, asymmetric information is realized among them, thus it is preferred for the profession, because they are totally competent. [1]

Due to the social and economic development the activities beyond the traditional financial services appeared in the financial market, and the willingness to invest has been also increased. The dynamic growth and technological development might carry different risk factors that the supervision had to respond at the same time when they appeared. [2]

The transformation of financial institutional structure, the new types of organizations at EU level affect the changes of supervisory rules, as a result of the growing economic life more and more problems arise in the market, so the national authorities have to conflict challenges. [3]

## SOME ELEMENTS OF THE INTERNATIONAL AND THE UNION RULES

I would highlight from the international regulation of the Basel II. Proposal, which was adopted in 2004. The three-pronged proposal i discusses separately in pillar I.: the minimum capital requirement for credit, market and operational risk; pillar II.: the supervisory control; pillar III.: disciplining force of market. [4] The use of certain stress tests were introduced in the supervisory control discussed in pillar II., which contribute to the elimination of external and internal shocks. [5] The introduction of stress tests increases the effectiveness of macro-prudential supervisory activity furthermore the examination of systemic mechanisms.

The Basel III. introduced the minimum liquidity requirements which are designed to keep the continuous solvency of the banking sector, in order to eliminate pro-cyclicality it pays attention to system risk over time. [6] The supervision has an important role in the realization of the liquidity requirements, and also helps the adaptation by monitoring activities.

In EU context, the new European financial supervisory structure started its operation in January 2011 which was formulated by the De-Larosière report. The aim of the two-pillar supervisory structure is that the financial markets are able to adapt more easily, furthermore to improve the operation of credit institutions and factors of competitiveness. The effectiveness lies in two pillars which are the level of micro-prudential and macro-prudential supervision. [7]

For example, if we highlight the stock exchange as a segment of the financial market - which in economic terms "the stock market homogeneous bulk goods organized, focused market." [8] – so it is justified by the supervisory convergence in its operation, because the institution itself contributes to economic cyclicity. The exchange transactions are three-party - the investor, issuer and merchantman - for them the stock exchange insures public and central space to trade capital market products. The regulation of the operation of the stock exchange is strict, it is necessary to act the proper part of economy. The authorize surveillance is needed for the formation and operation, the supervision accompanies the whole operation, in the various life stages it performs changing tasks. [9]

MiFID (=Directive 2004/39/EC of the European Parliament and the Council) following implement domestic legislation the regulated market appeared as a synonym for the stock exchange. The directive aims to consolidate the community legal framework for investment services and regulated markets, and enhanced support of two major goals was nominated in it, to protect investors and preserve market integrity by defining harmonized requirements for authorized intermediary activities, as well as, to promote the honesty, transparency, efficiency and integration of financial markets. [10]

In the 2014 year some major international regulatory processes appeared in the financial and economic life. It is important to emphasize the prudential regulation of directives and regulations (CRD IV./CRR), the Market Abuse Directive (MAD, MAD II.) for credit institutions and investment firms, which includes criminal sanctions for market abuse, and in relation to the capital markets are published the MiFID II./MiFIR. This publication is the first step in the process

that MiFID II./MiFIR requirements can be applied in practice, therefore the impact of the rules and regulation can be handled, the transparency of the financial crisis and financial markets can be improved and the protection of investors can be strengthened. [11]

## THE ESTABLISHMENT OF THE SUPERVISORY SYSTEM

### *The Financial Supervisory Authority*

*„The Financial Supervisory Authority is an autonomous regulatory agency responsible for oversight and monitoring of the financial intermediation system of Hungary and shall only be subordinated to laws.” [12]*

According to another approach, the Financial Supervisory Authority (hereinafter: FSA) was a budgetary organization with chapter rights, which had full authority over their own revenues, the expenditures were designed and financed independently as defined by the law. Its tasks have been written solely by law and it defined which fell within the scope of organizations. The purpose of supervisory activities is that the financial and capital markets operate smoothly and effectively, to protect the interests of customers as well as to ensure that the market will provide a transparent and fair view. The Authority examine continuously the compliance with the legislation and authority provisions, it work with foreign financial supervisors in close collaboration, providing regular information to each other in order to achieve consolidated supervision. [13]

The operation of the FSA was closed on 1 October 2013, and it was replaced by the National Bank of Hungarian (hereinafter: NBH) in each area, for example, private law rights and obligations of the FSA were exercised by NBH, in litigation and non-litigation procedures, procurement process was replaced, too. With this step, the NBH took over the role of the FSA, assimilated it, and provide all of the surveillance activities. The law came into force on 1 January 2014, so the period between October and December 2013 were covered by the transitional provisions. [14]

A summary table deals with the FSA's prudential inquires between 2010 and 2013 which is created by the NBH. It turns out that against who were investigations and also shows that on the base of inquires how much fine was given to the particular participants in the given three years.

1. chart

Summary table of prudential inquiries of the FSA between 2010 and 2013

<b>Type of institutional</b>	<b>Comprehensive inquiry between 2010-2013</b>	<b>Extraordinary inquiry between 2010-2013</b>
Commodity dealers	1	0
Investment firms	16	8
Investment management	26	3
Stock exchange	0	0
Discount firm	1	0
Central counter	1	0
Venture capital fund managers	7	0
<b>All</b>	<b>52</b>	<b>11</b>

Source: Based on <http://slideplayer.hu/slide/2161820/> (download date: 18.05.2015. 12:00) own construction

A total of 63 examinations were carried out in the relation of this period, the most prominent types of institutions that were examined in the circle of investment firms and investment managers. If we look at it in terms of proportions based on all of them, the former ones reached 38 per cent, and the latter ones were above 46 per cent.

*National Bank of Hungary*

The National Bank of Hungary is the central bank and the member of European System of Central Banks, as well as the European System of Financial Supervisors. [15] The change of monetary policy started with the base rate cut in August 2012. The real change was realized by the new central bank management and the new law, the medium-term low inflationary pressures were replaced by the persistently loose monetary conditions. In order to support sustainable development Growth Loan Program was realized, the profit of the NBH was paid higher attention so in 2013 more positive results were achieved. In this case, the integration of the NBH and FSA was the relevant change for us because of the stronger coordination of the monetary policy and financial regulation, and towards the operation of that and to ensure the financial stability need stronger assets. [16]

In respect of 2014-2019 the NBH developed a supervisory strategy based on different pillars, in that strategy there are two prominent values, the stability and confidence. The strategy covers the micro- and macro-prudential authority, the demolition, consumer protection and market supervision.

Related with the market supervision the activities are grouped around two major tasks. Firstly, the displacement of the unlicensed operators, that is why to establish the supervision which is based on effective, continuous monitoring

activities and create the market supervision, thus the unlawfully acting participants are filtered, and it can execute quick market cleaning. It manages the financial market innovations, and intensified collaboration can take place with the partner authorities. The second task as it is marked the need to eliminate deviant behaviour (market manipulation, suspicions of insider trading) effectively with the active supervision of financial markets and use the continuously improved data mining methods and rapid regulatory response into action in this regard. In addition, it is marked an active control of the public issuers and takeover rules plus the increase of the operation transparency. In relation to the capital market it aims to strengthen the role of the financial intermediation, such as EU development funds delivered efficient investments, as well as, the development of forms of financing outside the banking sector. The supervisory role on the capital market must be active for this to happen, it is necessary to confirm the assets of intensive products, institutional and market supervision and personal responsibility. [17]

The distinction between macro- and micro-prudential supervision indicates the importance of the task. The difference between these two ones is manifested in the comprehensive, set quantity that shall to be monitored. The macro-prudential supervision deals with exploration of the economic and business risks which threatens the financial intermediary system as a whole, while the micro-prudential supervision carries out the supervision and monitoring of specific, institutionalized financial intermediaries. Hungary made the FSA integration into the NBH organization to strengthen the Bank's supervisory functions, so because of the professional tensions and cost effectiveness the micro and macro-prudential supervisory function has already displayed at one place. [18] Lists among the basic tasks of the NBH to develop macro-prudential policies relating to the stability of the financial intermediary system as a whole. Within this basic task it reveals the risks which threaten the financial intermediary system as a whole, promotes the development of system-wide risk prevention and reduces the systemic risks which have been already established or abolished. [19]

Highlight one part of the macro-prudential supervision, the systemic risk itself typically can be classified into two types. In the first type may be mentioned pro-cyclicality risk, which is nothing more than an emerging systemic risk over a longer period of time. Under the pro-cyclical, during the boom credit the conditions get softer, the risks may be undervalued, the leverage increases, thus excessive risk-taking carries the risk. In the period of recession the process is contrary (risk aversion, curbing loans, leverage drop). Due to the recovery period operators, who carry things to excess, they do not always have the opportunity to emerge from this situation during the recession, this includes long-term adverse effects, because the chances of economic growth come to a halt. The other type is structural risk which is no more than the amount of risk factors at the institutions, which does not only lead to downfall, but also goes beyond. [20]

Resolution is a special insolvency proceeding, which relates to the financial institution or their group. The resolution as an appearance of a new institution was motivated by the 2008 crisis, because the troubled, systemically dominant banks or other financial institutions were supported by public funds of the state in order to maintain stability. The European Union in order to create a

controlled circumstance made Bank Recovery and Resolution Directive (BRRD, 2014/59/EU Directive). In Hungary, the Act XXXVII. of 2014 is concerned with the resolution, its conditions, instruments and procedures etc.. Although the NBH is the supply mission, as the national resolution authority carries out this activity completely independently, separate from the supervisory function. [21] The resolution mechanism is mandatory for all member states where they use euro, but the connection is provided for other EU countries, too. [22]

In the case of financial consumer protection is relevant to note that the 2013 Central Bank Act regulated down its the framework within the macro-prudential task because of excessive credit growth. Problems of foreign currency loans are incurred the liability side, and each of them is consumer protection issue that comes to the fore after 2008. The legal solutions were used for goods and products but they could not be used in the case of financial services, so it was needed a kind of new approach, which is insured the better protection for the customers. [23]

## CONCLUSION

The supervisory itself is so important that it is included in the Fundamental Law of Hungary as „*The National Bank of Hungary shall function as supervisory authority of the financial intermediary system.*” I examined the institutional changes of financial supervision in the aftermath of the 2008 crisis, in my opinion, the transformation of the institutional structure is not the only change. With the adoption of the Fundamental Law more detailed rules were developed, and thereby the Act of NBH became cardinal laws providing the relevant legal background, as an independent institution.

Following the crisis, a number of new regulations were published on international, EU and national level, the problems revealed wish newer and newer quick solutions. This process does not stop, because the cash flow takes place in seconds, financial market cannot be imagined as a stagnant stage, remaining within national boundaries scene. My point is that quick solutions come easily, when we find the source of the trouble, however, this market adaptation does not go smoothly, and the forecast is rarely possible. The pro-cyclicality, as a concept, is known to all of us, tits interval of steady has been declined over the centuries, which can cause problems in long-term.

To the initial question “Why the supervision of the financial market is justified?” my answer is the operation of the financial markets can be created only within the limits which protect the interests of consumers, but keeps in mind the stability of the market. The supervision is necessary in this way rights and obligations of all stakeholders will be equal, so the profit will be guaranteed in the long-term.

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