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The past year has seen a number of critically important bank regulatory initiatives reach interim conclusions.

In the European Union we have seen the finalisation and coming into force of the primary measures that are required to implement Basel III, as well as – at long last – political agreement on the Recovery and Resolution Directive and the principal elements of the banking union proposals. We have also seen the first foray of the European Commission into bank structural reform, with its controversial proposal for EU legislation on that subject, after the enactment of detailed domestic bank structural reform measures in a number of member states.

In the United States, the past year has seen the culmination of a number of regulatory initiatives, including the issue of final rules implementing the Volcker Rule and the issue of rules that will require large foreign banking groups to establish intermediate holding companies for their US subsidiaries. Both of these sets of rules stem from the Dodd-Frank Act: predictions that numerous legal careers would be made by that legislation are so far proving to be accurate.

I refer to these developments above as ‘interim conclusions’ because, of course, even though a period of primary rule-making has reached a conclusion, the full implications are still emerging. That said, there are helpfully more certainties now about the future direction of banking regulation than was the case a year ago. The combination of that fact, generally improving western economies and shareholder pressure has made many banks take the plunge and start to reorganise and restructure.

Recovery and resolution planning work remains a powerful driver of structural reform. It does not, however, require a particularly sophisticated legal and regulatory view to conclude that the world remains far from a position where we can have confidence that a global systemically important bank could be resolved in an orderly manner today without significant disruption and damage to the world economy. The fact that some regulators occasionally argue to the contrary disregards the detailed work that still has to be done so that governments and regulators may have a good chance of attaining that confidence in the next few years. But that work is, in general, progressing and reassuringly
shows no real sign of faltering yet as memories begin to fade of just how close the world came to economic calamity during the financial crisis.

Divergent approaches to structural reform in different countries could, however, make group-wide resolution more difficult to achieve. Localism, in the form of requirements that banking subsidiaries hold additional, more loss-absorbent capital and additional pools of liquidity, and have boards of directors with a significant independent membership, all have the potential to threaten the concept of a global banking group unless careful thought is given in such groups to how to address these challenges. The ways in which banking groups can best coordinate their relationships with multiple regulators are high on this agenda.

Perhaps the most difficult challenge facing banks in their relationships with their regulators is that of how to reconcile the need for close and cooperative working relationships with those regulators against the backdrop of seemingly never-ending conduct-related investigations and enforcement action. This difficulty varies according to which regulator is carrying out the investigation and the extent to which the investigation relates to matters that are historic and which the banking group concerned has taken steps to address. The challenge is clearly greatest where a major investigation concerns recent conduct and is led by a regulator with which the relevant bank requires good relations in order to achieve its commercial objectives to the satisfaction of its customers and shareholders.

It will be increasingly important for banks to appreciate the capacity of the more material investigatory and enforcement activity to shape business structures as much as structural reform itself. The changes to the ways in which certain markets and trading operations will be organised in the future in response to enforcement activity will be at least as significant as the changes that are brought to those markets and operations by, for example, resolution planning.

The upheaval that all of this implies for some banks’ corporate and business structures, as well as for their staff, is combining with changes to previously held assumptions about the profitability of certain activities as Basel III capital requirements bite. The result is uncertainty, but with some grounds for cautious optimism, at least for those banking groups that are less seriously affected by conduct investigations and are firmly on the road to developing simpler, more capital-efficient structures.

Banks that have adopted a properly integrated and global approach to structural reform will, in my view, reap the benefits. While, in the short term, that is likely to be more expensive from a resourcing perspective, in the long term it should achieve savings. It is all too easy to address each regulatory initiative as it comes along, not recognising that this reactive approach runs the risk of structural muddle and missing out on developing business models that address multiple regulatory concerns at the same time. It is to be hoped that more regulators start to recognise positive proactivity on the part of banks not just as commercial astuteness but as a contribution to the restoration of trust that is required to make bank regulatory reform a success.

One increasingly important aspect of reform in the banking sector concerns the capital structures of banking groups. The requirement for more and higher quality loss-absorbing capital under Basel III, coupled with the introduction of bail-in as a resolution tool in a number of important banking jurisdictions, means that banking groups are having to rethink which company or companies they will use to raise capital
and what form that capital will take. Particularly in Europe, the issue of additional Tier I
capital and other contingent capital instruments has added complexity to banks’ capital
structures and a need for banks to engage with current and potential investors to explain
those structures.

This fifth edition of *The Banking Regulation Review* contains submissions provided
by authors in 56 jurisdictions between late February and mid-April 2014, as well as the
chapters on ‘International Initiatives’ and the European Union. Preparing the chapters
has been a particularly onerous task for the authors this year because many of their clients
have now moved from observing the regulatory revolution that has taken place in the
banking sector to taking tangible steps to reorganise in order to make themselves fit for
the new world in which the sector finds itself. My thanks go to all of the authors for their
dedication in completing their chapters.

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**Jan Putnis**  
Slaughter and May  
London  
May 2014
Chapter 26

HUNGARY

Péter Köves and Szabolcs Mestyán

I INTRODUCTION

The Hungarian banking industry has undergone major changes since the beginning of the global economic crisis.

From a legislative perspective the formerly broadly regulated conduct of business rules have been replaced with detailed and rather strict provisions. This trend is ongoing and is expected continue. The introduction of a new Banking Act, as well as a new Civil Code in Hungary in 2014, together with the continuous inspections by regulators with respect to compliance with consumer protection and conduct of business rules (and the fines imposed on many banks recently), resulted in banks being obliged to focus more on the reshaping of their general terms than at any time before.

The portfolios of banks are laden with non-performing distressed assets, both in the retail and the corporate sectors. For many reasons, a market for these loans has not yet developed, but it is expected that loan and portfolio transfers will be the major transactions in 2014 and the coming years.

Both the political and economic climate (along with compulsory obligations set by the European Commission) have ‘encouraged’ banks to consider an exit from the Hungarian market. This process has already started, and while there are clearly some banks focusing on Hungary as a long-term strategic location for their businesses, it is expected that a number of financial institutions will leave – provided that they find a buyer – which is not easy given the difficult and very challenging times in which Hungarian banks are currently operating.

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Péter Köves and Szabolcs Mestyán are partners at Lakatos, Köves and Partners.
II THE REGULATORY REGIME APPLICABLE TO BANKS

On 1 January 2014 a new act entered into force in respect of regulating banking business in Hungary: Act CCXXXVII of 2013 on credit institutions and financial enterprises (the Banking Act). The primary purpose of the Banking Act is to implement Basel III into the Hungarian legal system. Its secondary purpose was to recodify banking provisions, since the former act (promulgated in 1996) had been subject to a substantial number of amendments throughout the years and had thus become progressively less consistent, structured and readable.

Consequently, the regulatory framework, in terms of services and the types of entities that may pursue such services, has not changed dramatically. For instance, the differentiation between credit institutions (banks, specialised institutions such as mortgage bond issuers and savings cooperatives) and financial enterprises remains the same. The list of regulated services changed only slightly. Accordingly, apart from introducing the Basel III rules, the regulation of banking is broadly the same as under the former regime.

Please could you add some text to deal with the legal structures of banks, including bank subsidiaries; branches of overseas banks; cross-border activities by overseas banks not having a branch in your jurisdiction; and, where applicable, mutual structures. This section should also comment on the basic structure, priorities, agenda and resources of the regulators.

III PRUDENTIAL REGULATION

i Relationship with the prudential regulator

The functions of the former Hungarian regulator, the Hungarian Financial Supervisory Authority were taken over by the National Bank of Hungary (NBH) in October 2013. Since then, the NBH has been responsible for both monetary policy and the regulation of financial institutions, investment and insurance service providers. The takeover of the functions was part of the Orbán government’s centralisation policy. Some argue that regulation became too centralised (e.g., even the insurance sector is supervised by the NBH) and raise criticism regarding the potential conflicts of interest between the monetary functions and the supervisory functions of the NBH.

Insufficient time has passed since October 2013 to be able to evaluate whether these concerns are justified, but so far it seems that positive synergies prevail over any real or assumed negative effect of the new situation.

One of the key areas in respect of which the NBH shows less activity is consumer protection. The topic is currently prominent in Hungary due also to the general financial climate and the fact that banks and lending regulation became politicised as a result of the still large number of households indebted in Swiss francs and euros); recently the Hungarian Competition Office has been far more active in matters affecting consumers than the NBH. It is expected though that, following the closing of the transition of functions, the NBH will also focus on these issues.

The Banking Act also implements corresponding EU legislation on prudential regulation, and consequently, a market participant familiar with the reporting requirements
and types of inspections and monitoring a regulator in other EU jurisdictions expects and conducts, will not be surprised by the Hungarian rules, which broadly correspond with these EU laws.

ii Management of banks

The primary objectives of the management regulation in the Banking Act are to ensure a transparent corporate structure, prevent conflicts of interest, facilitate the application of such procedures by which risks could be effectively identified, measured, monitored and mitigated, oblige the banks to follow a remuneration policy linked to the effectiveness of risk management and, in general, to maintain the undisturbed and effective operation of financial institutions and the trust vested into the sector.

The core principle that forms the basis of the detailed provisions regulating requirements with regard to shareholders and members of management is the ‘good business reputation’. The NBH has wide discretion in determining (on a case-by-case basis) what it considers evidence of such.

Members of the board and supervisory board (in the case of a branch, all managers) are responsible for compliance with prudential rules. Financial institutions must always be represented by at least two persons with joint signatory rights.

Conflict-of-interest principles are based on reporting obligations as well as on certain prohibitions. Other requirements aim to ensure that decisions are made in a financial institution’s interests and there is no room for undue influence by third parties. Financial institutions are also obliged to set up and operate an internal monitoring system and department.

Remuneration rules follow the principles set out in relevant EU laws. Remuneration of management and employees must be proportionate to the size and risks of the business, remuneration policy should not motivate employees to expose themselves improper levels of risk. The policy is prepared and enforced by the supervisory board, while the board of directors monitors this in tandem with the internal monitoring department. Any institution with a market share of at least 5 per cent must set up a remuneration committee, which is responsible for setting the remuneration of employees in charge of managing risks and ensuring compliance with laws.

Remuneration may consist of a base element and a performance-based element, and the latter may not exceed 100 per cent of the base salary. There is, however, an exception where the cap is 200 per cent, which may be applied if the general meeting of shareholders authorises such after detailed discussions of the reasons for applying the higher cap and the institution notifies the regulator of the proposal and the shareholders’ resolution prior to its application (in this case the financial institution has to certify to the regulator that applying a higher cap does not infringe prudential rules or EU laws).

When determining the performance-based element of the remuneration, the financial institution has to evaluate not only the performance of the employee but the performance of the entire department and financial institution as well. It is important to note that no undertaking may be assumed by the institution in respect of the performance-based element of the salary and the relevant amounts may be paid only if the financial position of the institution is sustainable and the actual performance provides adequate grounds for the ‘bonus’. The elements of the performance-based salary (e.g., percentage
of shares and other instruments) must also be elaborated in detail. The ‘bonus’ may not be paid in full at once, but has to be deferred for a period of between three and five years.

Branches of EEA institutions may apply the remuneration policy applicable in the Member States in which such institutions are registered.

iii Regulatory capital and liquidity

The Banking Act reflects the provisions of the EU Capital Adequacy Directive and does not contain provisions that are regulated by the directly applicable EU Capital Adequacy Regulation. The new Basel III-based capital adequacy rules come into force gradually, but most of the provisions should be in force from 1 January 2015.

iv Recovery and resolution

The framework for resolution of failed banks rests on three pillars. The first is the extraordinary loan available from the NBH. The principle is that if circumstances arise due to which the operation of the financial institution endangers the stability of the financial system, the NBH may grant a loan, provided that the restrictions related to monetary financing are complied with.

The second pillar is the power of the state to increase capital of a bank for the purposes of preserving and ensuring the stability of the financial system. This action may be implemented on the basis of a proposal of the NBH, either with the consent, and further to the request of, the financial institution, or ex officio, provided in the latter case that the government adopts a decree in respect of the particular financial institution the insolvency of which would result in serious damage to the Hungarian financial system. The trigger for adopting such decree is the point in time when the financial institution does not meet certain capital adequacy requirements. The shares to be acquired by the state upon a capital increase will be preference shares (either in respect of distribution or voting rights). Rules otherwise regulating the acquisition of controlling interests in financial institutions are not applicable in the event of such a capital increase.

The third pillar consists of the administrative measures of the regulator (NBH). The NBH has the power to apply a wide range of administrative steps in case a financial institution breaches the provisions of the Hungarian Banking Act, particularly if prudential obligations are not complied with. Such measures include the power to:

\[\begin{align*}
  a & \text{ instruct the institution to adopt a mitigation plan;} \\
  b & \text{ appoint a monitoring officer;} \\
  c & \text{ prohibit the payment of dividends and other distributions, the granting of loans to shareholders or assuming guarantee and similar obligations;} \\
  d & \text{ order the institution to comply with extra (additional) capital requirements;} \\
  e & \text{ order the institution to dispose of assets not required for the banking operation;} \\
  f & \text{ convene the shareholders’ meeting or to suspend the voting rights of certain shareholders, who, on the basis of facts available, endanger the prudent operation of the institution or the financial market.}
\end{align*}\]
It is a phenomenon unique to the Hungarian banking market that the conduct of business rules were not the primary focus of the legislator, the regulator, clients or the banks themselves. There were legal provisions regulating the principles of marketing, the way the general terms and conditions should be made available or the means available for clients to submit complaints, but consumer protection and banking behaviour were only loosely regulated and issues regarding these have rarely arisen.

The global economic crisis and the widespread focus on banks’ behaviour and responsibility for the crisis changed the situation dramatically. Not only were high banking sector taxes introduced, but consumer protection and conduct of business regulation also became a priority for governments (and, unfortunately, these also became the subject of political campaigning). Stricter and more detailed regulation was inevitable since in the years preceding the crisis, households and companies were indebted mainly in euros or Swiss francs; following the crisis, both interests rates and exchange rates increased, resulting in dramatically growing repayment instalments for the many borrowers with income in Hungarian forints.

The first attempts to deal with the situation targeted the regulation of provision of information and the barriers to amending general terms and conditions unilaterally. This was followed by restrictions on foreclosures and the introduction of such unorthodox measures as enabling retail borrowers to repay their loans at historical exchange rates or to continue to pay instalments at mandated exchange rates (while banks collect on a Hungarian forint account the amounts of debt arising out of the difference between the mandated exchange rate and the market rate, generating a debt in Hungarian forint to be repaid at a later stage).

The Hungarian Banking Association adopted a Code of Conduct in 2009 in respect of retail loan clients. The core content of this code is a list of grounds on the basis of which banks may unilaterally amend their general terms. The purpose of the list was primarily to make such unilateral amendments more transparent. Although this is widely used, some elements of the list became controversial since court decisions in the following years declared amendments on this basis to be invalid.

The regulator also became very active in protecting consumers. Significantly increased fines are being imposed on banks, not only by the financial market supervisor, which is closely watching the compliance with the conduct of business rules, but also by the Hungarian Competition Office on the basis of unfair market behaviour. The amount of banking litigation reached record levels. Due to the failure of the laws in force before the crisis to regulate very important matters (such as the maximum interest rate that may be applied with regard to retail clients, the exchange rates that may be determined when collecting Hungarian forints to discharge a Swiss franc or euro payment, or the conditions of prepaying loans), courts – in many cases – were not in a position to rule in favour of the customers, since the laws were either silent or very vague on these issues and therefore only the contractual provisions and general principles of consumer protection rules could be relied on. To rectify the situation, Parliament enacted several acts concerning these issues, which are now regulated. The underlying problem – the existing loans – remains as most of the new rules cannot be applied retrospectively, but only in respect of new loans. Consequently, in order to resolve the problem of existing borrowers, the
legislator had to find ways to interfere in the civil law contractual relationship of the banks and borrowers. This process is still pending, and its outcome will largely depend on an imminent (at the time of writing) ruling of the European Court of Justice and the stare decisis of the Hungarian Curia (Supreme Court) to be finalised on the basis of such ruling.

V FUNDING

More than half of the Hungarian banks are subsidiaries of foreign (primarily EEA-based parents). Consequently, funding is typically provided by the parents through capital contributions and interbank loans. Traditional funding, such as collecting deposits became increasingly important from 2009 onwards. Shares of some Hungarian banks are traded on the stock exchange. Finally, as one might expect, liquidity facilities are available from the NBH in various form (loans and open market instruments).

VI CONTROL OF BANKS AND TRANSFERS OF BANKING BUSINESS

i Control regime
In respect of the control regime, the Hungarian Banking Act follows the provisions of the EU Acquisition Directive, in many cases on a word-by-word basis.

ii Transfers of banking business
Transfer of all or part of the assets of a bank could take a number of forms. Transferring a portfolio of deposits and other repayable financial instruments requires the approval of the NBH. The approval is refused if the transfer endangers the fulfilment of the obligations assumed under the deposit agreements. Security interests do not cease to exist during the course of such transfer and consent of the client is not required, but within 30 days of receiving approval from the NBH, the transferee has to notify all counterparties.

The transfer of loans and loan participations is possible. Under the former Civil Code, the means of such transfer (in the case of Hungarian law, governed underlying agreements) was the assignment of rights and receivables and simultaneous assumption by the transferee of obligations. In respect of the assignment of rights or receivables, no consent is required from the debtor (although in order to perfect the assignment and enable the transferee to enforce its rights against the debtor, the transferor has to notify the debtor of the assignment). Based on case law, this is the case even if assignability is restricted or prohibited under the agreement between the transferor and the debtor (a breach of which clause may nevertheless give rise to claims for damages). For the part assuming obligations, however, obtaining the consent of the debtor is recommended since, in the absence of such consent, the assumption is not effective as regards the debtor. These consents are usually given contractually at the outset, contained in the principal agreement.

The new Civil Code, which entered into force on 15 March 2014, introduced the concept of novation, but, according the new Civil Code, security interests cease to exist upon novation, although the security provider may consent to the establishment of new

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security interest with the same ranking position. This is a major risk for transferees and it is for this reason that lenders will be expected to seek agreement with the borrower to contract out of this provision.

There is no specific law on securitisation in Hungary. Such transactions may be made under the framework of general civil and commercial law principles (e.g., assignment of receivables).

The following particular issues must be taken into account when structuring various types of transfer in Hungary:

a. whether a licence is required (e.g., purchasing receivables may trigger licensing requirements);
b. whether the transferor remains the servicer (this is relevant from notification perspective, and could be essential in respect of licensing and enforcement);
c. whether transfer is restricted under underlying agreements;
d. whether security interests survive the transfer, and – even if they survive – whether there is any need for re-registration of the beneficiary to ensure due enforceability;
e. to the extent the general terms of the transferor were applicable to the underlying contract, whether tripartite or bilateral amendments are needed (this is relevant especially if a Hungarian transfers particular loans to a foreign bank); and
f. whether the approval of the regulator (or in the event of a large portfolio deal or M&A deal, the approval of the Hungarian Competition Office) is required.

VII  THE YEAR IN REVIEW

There were three major events in the past year that will have a substantial impact on the future development of the Hungarian market. The first was that the functions of the regulator or supervisor were taken over by the NBH. The second development was the introduction of the new Hungarian Banking Act, which, in the view of many, will be subject to as many amendments as its predecessor, due to its rushed preparation and enactment, and the failure to address issues that have – for many years – caused uncertainties for market participants. The third is the continuing search by the government for solutions to the problems faced by the many borrowers with foreign exchange-denominated loans.

VIII  OUTLOOK AND CONCLUSIONS

Legislation to deal with the situation with foreign exchange loans will be the key issue in the near future. Following the end of the current uncertainty shaping business and strategic decisions in that regard, substantial movements and changes are expected. The exits of key market players from the market for various reasons (losses, European Commission resolutions, bad market environment, etc.) will continue, if buyers can be found. If buyers for whole banks cannot be found, the sales of portfolios, particular business lines or assets may be compromise solutions. The ultimate explicit intention of the government is that at least 50 per cent of the Hungarian banks should remain Hungarian hands.
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Péter Köves heads the firm’s banking and finance practice. He has extensive experience in advising financial institutions, leading Hungarian and international companies, banks, advisory firms and government institutions on all aspects of their operation. He developed a well-recognised reputation as a professional in asset finance deals and in dispute resolution and litigation. He is an arbitrator in the Arbitration Court linked to the Hungarian Chamber of Commerce.

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