THE BANKING REGULATION REVIEW

Sixth Edition

Editor

JAN PUTNIS

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CONTENTS

Editor’s Preface ...............................................................................................................xi
Jan Putnis

Chapter 1 INTERNATIONAL INITIATIVES ............................................................... 1
Jan Putnis and Tolek Petch

Chapter 2 ANGOLA ............................................................................................... 25
Mafalda Oliveira Monteiro and Bruno Sampaio Santos

Chapter 3 ARGENTINA ............................................................................................ 36
Santiago Carregal and Diego A Chighizola

Chapter 4 AUSTRALIA ............................................................................................. 48
Jennifer Barron, Hanh Chau, Peter Feros, Paula Gilardoni, Deborah Johns and Peter Reeves

Chapter 5 BARBADOS ............................................................................................ 62
Sir Trevor Carmichael QC

Chapter 6 BELGIUM ................................................................................................. 71
Anne Fontaine and Pierre De Pauw

Chapter 7 BOLIVIA ................................................................................................... 83
Carlos Pinto-Meyer and Lindsay Sykes

Chapter 8 BRAZIL ..................................................................................................... 91
José Eduardo Carneiro Queiroz

Chapter 9 CAMBODIA .............................................................................................. 96
Bun Youdy
<table>
<thead>
<tr>
<th>Chapter</th>
<th>Title</th>
<th>Pages</th>
<th>Authors</th>
</tr>
</thead>
<tbody>
<tr>
<td>10</td>
<td>CANADA</td>
<td>113</td>
<td>Scott Hyman, Carol Pennycook, Derek Vescy and Nicholas Williams</td>
</tr>
<tr>
<td>11</td>
<td>COLOMBIA</td>
<td>129</td>
<td>Luis Humberto Ustáriz</td>
</tr>
<tr>
<td>12</td>
<td>DENMARK</td>
<td>143</td>
<td>Morten Nybom Bethe</td>
</tr>
<tr>
<td>13</td>
<td>EGYPT</td>
<td>154</td>
<td>Aly El Shalakany</td>
</tr>
<tr>
<td>14</td>
<td>EUROPEAN UNION</td>
<td>163</td>
<td>Jan Putnis, Timothy Fosh and Helen McGrath</td>
</tr>
<tr>
<td>15</td>
<td>FINLAND</td>
<td>186</td>
<td>Janne Lauha and Hannu Huotilainen</td>
</tr>
<tr>
<td>16</td>
<td>FRANCE</td>
<td>197</td>
<td>Olivier Saba, Samuel Pariente, Jessica Chartier, Mathieu Françon and Béna Mara</td>
</tr>
<tr>
<td>17</td>
<td>GERMANY</td>
<td>218</td>
<td>Thomas Paul and Sven H Schneider</td>
</tr>
<tr>
<td>18</td>
<td>GREECE</td>
<td>232</td>
<td>Vassilis Saliaris and Eva Galigali</td>
</tr>
<tr>
<td>19</td>
<td>HONG KONG</td>
<td>253</td>
<td>Laurence Rudge and Peter Lake</td>
</tr>
<tr>
<td>20</td>
<td>HUNGARY</td>
<td>270</td>
<td>Péter Köves and Szabolcs Mestyán</td>
</tr>
<tr>
<td>21</td>
<td>INDIA</td>
<td>278</td>
<td>Cyril Shroff and Ipsita Dutta</td>
</tr>
</tbody>
</table>
Chapter 34 PHILIPPINES ................................................................. 462
Rafael A Morales

Chapter 35 POLAND ................................................................. 478
Tomasz Gizbert-Studnicki, Tomasz Spyra and Michał Bobrzyński

Chapter 36 PORTUGAL ............................................................... 493
Pedro Cassiano Santos

Chapter 37 ROMANIA ................................................................. 511
Alexandru Birsan, Carmen Peli and Alexandra Manciulea

Chapter 38 RUSSIA ................................................................. 525
Vladislav Skvortsov and Stefan Wolfgang Weber

Chapter 39 SINGAPORE ............................................................. 539
Francis Mok and Wong Sook Ping

Chapter 40 SOUTH AFRICA ...................................................... 551
Ina Meiring

Chapter 41 SPAIN ................................................................. 563
Juan Carlos Machuca and Tomás Acosta

Chapter 42 SWEDEN ............................................................... 583
Fredrik Wilkens and Helena Håkansson

Chapter 43 SWITZERLAND ......................................................... 594
Shelby R du Pasquier, Patrick Hünerwadel, Marcel Tranchet,
Maria Chiriaeva and David Violi

Chapter 44 TANZANIA ............................................................. 614
Wilbert B Kapinga, Rehema A Khalid and Kamanga W Kapinga

Chapter 45 UKRAINE ............................................................... 624
Alexander Borodkin, Anna Sisetska and Olena Nikolenko
Chapter 46  UNITED ARAB EMIRATES.............................................................. 636
  Amjad Ali Khan and Stuart Walker

Chapter 47  UNITED KINGDOM ............................................................... 644
  Jan Putnis and Nick Bonsall

Chapter 48  UNITED STATES ................................................................ 668
  Luigi L De Ghenghi

Chapter 49  VENEZUELA...................................................................... 720
  Pedro Planchart Pocaterra and Andrés Guevara Basurco

Chapter 50  VIETNAM.......................................................................... 730
  Nasir PKM Abdul and Pham Bach Duong

Appendix 1  ABOUT THE AUTHORS......................................................... 751

Appendix 2  CONTRIBUTING LAW FIRMS’ CONTACT DETAILS ...783
EDITOR’S PREFACE

While the pace of new rulemaking affecting banking groups has slowed somewhat in Europe and the United States in the past year, the debate about the future of global banking rages on, not least because implementation of the vast body of rules made since the financial crisis continues. If anything, the debate has become a more complex one, with a number of new fronts opening. Implementing complex new rules is, of course, generally more difficult than making them, and in many areas of activity rules that took shape some time ago are only now exhibiting their shortcomings and unintended consequences.

Questions about ‘too big to fail’ remain, but with gradually increasing realism among regulators, some governments and banks ask themselves about how this issue might best be managed in the long term. There is now greater recognition that painstaking recovery and resolution planning was not just an urgent post-crisis task but must remain a critical feature of banking supervision in perpetuity. Indeed, the list of points on which regulators should improve cross-border coordination on recovery and resolution matters remains formidably long. There is also a risk that while ‘too big to fail’ was the most well known and eye-catching phrase to emerge from the financial crisis, any attempt by governments to force or catalyse the break-up of large banking groups would risk neglecting the importance of the ‘too inter-connected to fail’ problem, which is, of course, far less a function of the size of banks.

The past year has seen further large fines for banks from conduct regulators, most notably in the context of the spot FX markets. Many bank prudential regulators are, sensibly, thinking more seriously now about the implications of these fines (and associated litigation) for the prudential supervision of the banks affected and, potentially, for financial stability itself. The ‘conduct agenda’, as it is now frequently called, has moved on in other ways in some countries, including increasing discussion among regulators about competition (antitrust) aspects of wholesale as well as retail financial markets. This will begin to create new and, in many cases, unwelcome challenges for large banks.

Return on equity continues to be a significant challenge in the banking sector, with signs of increasing shareholder pressure on some banks. This may add a further
dimension to structural reform in addition to the existing regulatory one. In some cases, particularly where activist investors are concerned, all involved would do well to remember that shareholder activism lay behind some of the more disastrous mergers and acquisitions in the banking sector before the financial crisis. While it can be expected that regulators in most important financial jurisdictions will be more vigilant in assessing the viability of major transactions in the sector now than they were before the crisis, boards of directors of banks will also need to avoid the temptation to give in to short termism in the face of poor shareholder returns. This is arguably particularly the case in an environment where market restructuring and new technology present long-term opportunities for some banks as well as threats.

Governance of banking groups continues to be high on the agendas of many regulators around the world. Directors of banks in the UK, many other European countries and the US rightly focus increasingly on whether they are discharging their regulatory obligations properly when taking significant decisions, and whether their knowledge (and their ability to oversee) the businesses for which they are responsible is sufficient. A cynical bystander would, however, continue to say that in a global bank with tens of thousands of employees worldwide, good governance structures will only ever play a limited role in reducing the risk of a calamity on, for example, a trading desk, and that good luck (or bad luck) is more likely to determine success or failure in global compliance. That is surely too cynical a view in light of the significant strides that many banks have made to improve their governance and oversight in recent years. However, it remains a view with some validity in relation to emerging threats that are not yet generally well understood. These include many cyber-related risks, not just the possibility of the use of banks’ IT systems by criminals but also the threat to financial stability posed by vulnerabilities (and in some cases unreliability) in systems used to settle payments and securities transactions. Bank governance in the context of the use of banks for criminal purposes, including tax evasion, has continued to have a very high profile over the past year.

Important developments in prudential regulation in the past year include further advances in the EU towards implementation of the Recovery and Resolution Directive and the Financial Stability Board’s proposals on Total Loss-Absorbing Capacity (TLAC). TLAC looks set to continue to dominate debates on capital structure and funding in the banking sector this year, particularly on the difficult question of where and how TLAC should be ‘positioned’ within groups of companies in order to facilitate their chosen resolution strategy.

This sixth edition of *The Banking Regulation Review* contains submissions provided by authors in 48 countries and territories in March and April 2015, as well as the customary chapters on International Initiatives and the European Union. It is a great privilege to share space in this book with such a distinguished and interesting group of banking and regulatory lawyers from around the world, and I would like to thank them all again for their participation (and those authors who have joined the book for the first time this year).

My thanks also to Shani Bans, Nick Barette and Gideon Roberton at Law Business Research Ltd for their further unusual levels of patience and skill in compiling this edition and for continuing to encourage the participation of the authors.
The partners and staff of Slaughter and May continue to inspire and innovate in the area of banking regulation, and to tolerate the time that I spend on chapters of this book. Particular thanks go to Ben Kingsley, Peter Lake, Laurence Rudge, Lucy Bennett, Nick Bonsall, Edward Burrows, Tim Fosh, Helen McGrath and Tolek Petch.

Jan Putnis
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Chapter 20

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. The introduction of a new Banking Act, a new Civil Code and the so-called ‘Fair Banking Act’ 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), have resulted in banks being obliged to focus more on the reshaping of their general terms than at any time previously.

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 there are more and more discussions taking place about the ways of facilitating the development of such market and the need to amend certain laws to that end. The National Bank of Hungary (NBH), in a joint project with the European Bank for Reconstruction and Development, issued a report on the obstacles and potential incentives affecting the non-performing loan market, and formulated a (non-binding) ‘to do list’ for future years.

Both the political and economic climates (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, a number of financial institutions have left, and others will leave, provided that they

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find a buyer, which is not easy given the difficult and very challenging times in which Hungarian banks are currently operating.

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 (Banking Act). The primary purpose of the Banking Act is to implement Basel III into the Hungarian legal system. Its secondary purpose is 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 became 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.

Most of the banks are financial institutions or specialised financial institutions (for instance, mortgage credit institutions). Two major banks were acquired by the state or state-owned entities in 2014, and the extent of state ownership in the sector is expected to increase in 2015. There are a number of subsidiaries of foreign (including Austrian, Italian and German) banks. Some of the large international financial institutions also operate a branch in Hungary. In principle, the local conduct of business regulations also apply to branches, while prudential regulation is the responsibility primarily of their home regulators. Offering cross-border services (without having a physical presence in Hungary) by banks regulated in a Member State of the European Union is also widespread, in particular in the corporate and interbank sectors.

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 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 criticisms 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 (regarding the banking sector) that positive synergies prevail over any real or assumed negative effect of the new situation.
The Banking Act also implements corresponding EU legislation on prudential regulation; 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.

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 in 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, and the remuneration policy should not motivate employees to expose themselves to 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., a 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 are coming into force gradually, although most of the provisions entered into force by 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.

Hungary has implemented Directive 2014/59/EU on establishing a framework for the recovery and resolution of credit institutions and investment firms. The resolution regime made available under the Directive may be applied by the NBH to reach the objectives of the implementing act. The main objectives are the following:

- **a** ensuring continuity of critical functions;
- **b** avoiding adverse affects to the financial system;
- **c** protecting public funds by minimising reliance on extraordinary public financial support;
- **d** protecting depositor interests; and
- **e** protecting client funds and client assets.

The type of tools available to achieve such objectives and the form of the resolution process follows what is stipulated in the framework Directive. The tools applied or to be applied in a given resolution process are set out in the resolution plan prepared by the NBH. The particular resolution document is not public.
The third pillar consists of the administrative measures of the regulator (the NBH). The NBH has the power to apply a wide range of administrative steps in cases where 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:

- instruct the institution to adopt a mitigation plan;
- appoint a monitoring officer;
- prohibit the payment of dividends and other distributions, the granting of loans to shareholders, or assuming guarantee and similar obligations;
- order the institution to comply with extra (additional) capital requirements;
- order the institution to dispose of assets not required for the banking operation; and
- convene the shareholders’ meeting or 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.

**IV CONDUCT OF BUSINESS**

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 the 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 forint account the amounts of debt arising out of the difference between the mandated exchange rate and the market rate, generating a debt in 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 monitoring 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 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, 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.

In 2014, further (and probably final) rules on settlement regarding former loan arrangements were introduced. The NBH developed a complex formula on the basis of which banks have to make settlement with their consumers by late spring of 2015. By way of new legislation relating to general terms and conditions of banks, it has been presumed (with retrospective effect) that such terms and conditions of banks have been unfair in the past decade. Amendments were also made to existing conduct of business regulations in the autumn of 2014 (the Fair Banking Act), which detail the rules of the referred settlement, and impose (on the basis of lessons learned following the financial crisis) additional obligations to provide information and disclose data before a consumer enters into a financial agreement.

V  FUNDING

Many 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 might be expected, 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.
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 the 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 by underlying agreements) were 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 a new 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 ‘transfer of business’ regime under Hungarian law. There are regulated procedures in respect of certain banking products (e.g., in respect of deposits, as referred to above), but this does not add much to a transaction where other products are also to be transferred, or where the given product (the transfer of which is regulated) is linked to other products (e.g., no regulated process is available regarding a credit card or an overdraft, while the transfer of a deposit account – the existence of which is a requirement relating to both products – is regulated). Consequently, transfers of business may be implemented only through a complex process where substantive law (in particular, the Civil Code) should have as much relevance as the Banking Act itself. An alternative solution could be a demerger, whereby the business to be transferred is separated from the other business of the transferor, then allocated to a vehicle, thus enabling a share transfer to be made. The principal drawback of this alternative may be that the vehicle should be licensed.

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, factoring).
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 the notification perspective, and could be essential in respect of licensing and enforcement);

\[c\] whether the 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

Three major events in the past year will have a substantial impact on the future development of the Hungarian market: the substantial increase of state interest in banks; the introduction of a number of important laws affecting the banking business in Hungary; and welcomed attempts to facilitate the tradability of non-performing loans.

VIII OUTLOOK AND CONCLUSIONS

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 sale 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 Hungarian banks should remain in Hungarian hands. It is also hoped that the market for non-performing loans will finally develop and that transactions will be conducted.
Appendix 1

ABOUT THE AUTHORS

PÉTER KÖVES
Lakatos, Köves and Partners
Péter Köves is the senior partner of the firm. 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 has 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.

Mr Köves is one of the pioneers of the introduction of complex and structured financial techniques to Hungary, such as PPP and project finance. In 2004, the Minister of Economy and Transport granted him a ministerial award for his outstanding professional activity in the introduction of PPP in Hungary.

He obtained a diploma in law from the Faculty of Law and Politics at the Eötvös Loránd University in 1983. In 1991, he established Köves & Partners, and later joined Clifford Chance in 1993 where, between 1995 and 2009, Mr Köves was a partner. In 2009 he became a founding partner of Lakatos, Köves and Partners Ügyvédi Iroda.

SZABOLCS MESTYÁN
Lakatos, Köves and Partners
Szabolcs Mestyán is a partner and head of the firm’s banking and finance practice. He has developed expertise in and acquired knowledge of asset and project finance, as well as the Hungarian law aspects of securitisation matters. He is regarded as an up-and-coming and cutting-edge expert in capital markets transactions, in aircraft finance and in banking consumer protection matters.

He obtained a diploma in law from the Faculty of Law and Politics at Eötvös Loránd University in 2005. Currently, he is a postgraduate student of the University of London. He joined the firm in 2005, and became a partner as of 2014.
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