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Changes in the prudential regulation of money and capital markets in Hungary

Theses of doctoral (PhD) dissertation

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1. INTRODUCTION

1.1 Antecedents and objectives of the dissertation

The researches of the author focussed around the changes of the recent years that occurred in the regulation and supervision systems of financial groups and, in particular, the bancassurance companies. The primary objective was to reveal the possibilities and dangers of operation within the group, from the aspects of ownership and control alike.

However, the secondary mortgage market crisis, which broke out in 2007 and has caused worldwide damages since 2008, has not only rearranged the world but also the logic of the dissertation. Using the knowledge he has so far obtained through his research, the author set the goal of finding the answer to the question as to how the global collapse could have been avoided and what changes the occurred crisis may ignite in the global money and capital market systems. To this end, he following questions need to be answered:

- what role does the Washington Consensus have in the collapse of the financial systems?
- what indications were visible before the financial crisis broke out?
- how effective were the measures adopted by the EU and Hungarian authorities (PSZÁF, MNB, Government)?

- what consequences does the Hungarian control have on the operation of the financial groups?
- how will the crisis influence the world economy?
- what changes of supervision and regulation will be necessary in the future?

The greatest emphasis in the dissertation was placed on the effects of the crisis on the regulation of the Hungarian money and capital markets, which, naturally, is closely related to the changes that occur in the European Union. The dissertation focuses on the problems connected to the supervision and regulation. The objective is to formulate such statements and recommendations on regulation that may be helpful to prevent a crisis similar to the present one.

1.2 Topicality and the applied methodology

As the dissertation is prepared, the financial crisis is still at its height, the writedown of companies reach a total of 1,000 billion dollars and the losses caused by the setback of world economy growth are already beyond estimation. Although the dramatic suspicion, accompanying the crisis, has somewhat decreased, the normal operation of the financial systems is still far away, kept alive artificially. As these lines are being typed, the 44th president of the United States has only been in office for a few days but, apparently, he and his team are using all their force to solve the situation. He has announced a more than 800 billion dollar bailout package, the goal of which is to restore the economy, in crisis for nearly a year. The United States has already pumped money in the range of a thousand billion dollars into the various systems, which is approved by the rest of the world as, admittedly, prime responsibility lies for them.

The majority of the developed and developing economies of the world have been in recession for a quarter but the descent is not yet over. Unemployment and the number of bankruptcy proceedings increases at a dizzy speed. One thing that has not even started is calling those responsible to account. Apart from one or two faint attempts, it has not yet been revealed who actually caused the crisis that collapsed the world economy for years. The author concentrates on why instead of who.

As suggested above, the topic could not be more relevant. With his dissertation, the author would like to encourage himself and others to carefully follow the most devastating financial and world economy crisis in decades, as well as assist the work of decision-makers with his research.

Methodology of the research

Primary and secondary research is essential for the provision of information. The spine of the applied methodology was tracing, analysing the primary sources and incorporating them into the dissertation. In addition, the author also immersed into the wider analysis of the special literature related to the financial market, which he built into his dissertation after critically processing them himself.

Secondary information was provided by the professional forums connected to the author's position and the continuous consultations made with the Regulation Department of the Financial Supervisory Authority (PSZÁF).

1.3 Contents and structure of the dissertation

The dissertation starts with the introduction and examination of the Washington Consensus and the Maastricht Treaty. At the end of the 1980s, when Hungary was only coming to terms with the concept of democracy, the foundations of world economy were laid down. One foundation stone of worldwide integration became known as the Washington Consensus, which incorporates the instances of conventional wisdom that should have served as guideline for the developing, the former socialist and the most developed countries at the same time. The Maastricht Treaty, which was the EU's response to globalisation, accepts the guidelines accepted in Washington, while trying to retain the achievements and long-term goals of European integration.

From the end of the 1980s the money and capital markets enjoyed more and more freedom and it gradually became widely accepted that the markets were able to regulate themselves. The expansion of the new systems was called a regulated, worldwide reform process. The problem was made worse by the fact that the American financial administration contributed to the present situation not only by failing to apply the proper regulation but in several cases it induced the market anomalies itself. After all, one of the illustrious advocates of the "self-regulating market principle" was no other than Alan Greenspan, who managed the Fed, the central bank of the USA, for nearly 20 years.

The dissertation demonstrates what new financial products rampant liberalisation and deregulation generated and what effects they had on the operation of the financial systems.

The author reviews the development of the Hungarian regulatory and supervisory system, looking back on the 20 years since the changing of the regime. The dissertation also presents the regulatory changes, introduced due to the EU membership, and gives a detailed description of the birth of Hungarian supervisory system, which is modern even by international standards. Regulatory and supervisory systems are introduced related to the different periods. In addition to presenting the draft directives and recommendations of the European Union, it is also examined what effects they have on Hungary's financial system.

In the period following the changing of the regime, the Hungarian and Central European financial sector underwent an enormous development, in harmony with the international processes. It took about two decades for the Hungarian economy to get from socialist planned economy to the developed institutional system of market economy. The dissertation presents how the financial market structure transformed in Hungary.

The present crisis is often compared to the Great Economic Depression in 1929-33. Therefore, the author examines the interactions between the crises with the help of the theories of Keynes, Tobin and Friedman.

Then the evolution and expansion of the American secondary mortgage market crisis are introduced, paying special attention to the impacts on the Hungarian financial system.

Spectacularly importing into Hungary, the crisis immediately dried up the government security market, sending the Hungarian forint into historic depths, while forcing the stock exchange to take a killing descent for days.

The disorder of the interbank markets and the increase in the interbank yields pressed the central banks to intervene. The exact nature and significant of the responses made by the central banks can only be properly evaluated if we know the market actions the central banks apply in a normal market environment and the main features of their general market toolkit. The second half of the dissertation provides comprehensive information on this, as well as the measures the central banks and governments made to respond to the crisis.

Then the domestic regulatory and supervisory practice of the financial groups is examined, paying special attention to the examination of the financial and insurance submarkets, relevant from the aspect of these groups. The various subchapters offer insight into the draft directives of the European Union and their domestic effects.

2. RESEARCH RESULTS

Thesis 1: The unrestricted expansion of globalisation led to the dramatic setback of the world economy.

The Washington Consensus and globalisation, strongly supported by the United States, seemed to have set the world economy on a lasting growth track in the past two decades. Undoubtedly, it had numerous advantages but one of the main deficiencies was that it did not count with human voracity. The unceasing race for profit and lobbying that ignored the interests of the nations diverted world economy to the wrong direction. On the other hand, the secondary mortgage market crisis, reducing the economies of the world into lasting, deep recession, is clearly attributable to globalisation, as the cross-border financial multi-institutions could easily infect practically any point of the world with their damaging products.

Thesis 2: Instead of maintaining prudent operation, regulation paid too much attention to intensifying the market competition.

The previously mentioned striving for profit and the appearance of the multitude of market players jointly led to the situation where the innovation of financial products and systems gained ground at the expense of prudent operation, which occurred partly in relation to products (e.g. new financial tools) and the processes (e.g. risk management methods). Regulators also realised that the more effective resource allocation contributed to economic growth but they did not see in all cases what dangers this might pose. Market competition must be confined within limits and it must by no means be superior to prudent operation.

Thesis 3: In the financial sector, fund managers, responsible for immense wealth, often missed the necessary professional knowledge; therefore they further increased the extent of damages.

The panic and damages caused by the crisis were increased by the fact that part of the fund managers and traders (e.g. securities and foreign exchange) did not have the necessary professional background to realise the seriousness of the situation. With their decisions and statements, they further deepened the turbulence of the money market, which then caused serious damages in the processes of the real economy. Much more attention will have to be paid to education in the future and make sure that only those with the proper professional experience and knowledge should fill in the positions. Financial accountability will also have to be introduced over a certain volume and it will have to be strictly applied if needed.

Thesis 4: The bankruptcy of the Lehman Brothers showed that, over a certain company size, saving a bank costs much less than its bankruptcy. The principle of "too big to fall" should by no means be ignored.

The collapse of the investment bank on 15th September 2008 started the most devastating wave of the financial crisis to date. The American government did not provide protection to the bank, which thus fell to its pieces. What might have been in the background is not clear at the moment but the market processes proved how bad the decision proved to be.

Thesis 5: The importance of the role the government takes should not be minimised as this crisis showed that it is only the various governments and states that can provide appropriate help.

It is the direct consequence of the previous thesis that the role of the state, as opposed to the efforts of deregulation and liberation, should not be reduced. The stable operation of the financial sector necessitates the appropriate level of central control. But it important to find the appropriate balance as it is equally unhealthy if the state plays excessive role. Once again the crisis brought to surface the ideas emphasising the necessity of state influence, described in Keynes' book titled The General Theory of Employment, Interest and Money. The Keynesian economics has its renaissance in North America and Western Europe.

Thesis 6: In order to avoid or shorten the recession, the governments have to announce a comprehensive package of measures.

The states hesitated for too long and failed to make meaningful decisions in due time. Several governments believed that the problems could be stopped at the borders. When they could not do this, they started to rush to create various packages to manage the crisis. However, the efficiency of these packages was variable and mostly weak in intensity. The impacts a crisis of this magnitude has on the real economy can only be reduced with harmonised packages of measures, introduced in due time.

Thesis 7: The present monetary toolkit of central banks could not manage the financial crisis effectively.

Management of the crisis using central bank actions causes dilemmas, which refer to the role the central banks play in the financial system. If we expect the bank of banks and its tools to be able to influence credit surcharges in financial market panic situations with loss of confidence like today's crisis, we have to admit the inadequacy of the present tools. It is true simply because the tools of the central banks were not designed for this function but to achieve their operative goal related to the short-term interbank yield in normal times, effectively and securely, yet preserving the functions of the market. The crisis showed what exactly the tools of the central banks are capable for in extraordinary situations. If a central bank temporarily raising the amount of allocated central-bank money of open market operations for its partners, modifying the performance of mandatory reserves, it solves none of the structural problems of the credit market. Today central banks do not have the necessary tools to be able to influence risk-taking willingness directly, through operations.

3. NEW AND ORIGINAL SUGGESTIONS AND RESULTS

Thesis 1: Markets are unable to control themselves; they must not be left without central supervision.

The view that ruled and determined the world's money markets, saying that the markets can regulate themselves, has failed. A good example is that nobody was willing to credit the banks dealing with securitisation in the deepening financial and confidential crisis, due to the strong insolvency. This in many cases led to the bankruptcy of the bank, or would have led there if the state, as the final rescuer, had not provided significant and immediate capital injection for the bank. The price had to be paid in the end as in most cases the state became the determining or majority owner of the bank in return for the loan.

Thesis 2: Supervisors did not realise the dangers of the secondary mortgage market crisis in time.

The initial signs of the crisis were visible as early as in 2006 in the United States after the problems of the secondary mortgage market started to get to the surface, following the burst of the "property bubble". In addition to the fact that the increase of house prices significantly declined, the higher interest level also contributed to the growth of repayment problems. Due to deregulation, states and supervisors were in many cases forced to view the events from a defenceless position. However, we can establish that supervisors should still have realised the situation and draw the attention to the extraordinary dangers at least by publishing recommendations. This never happened. Professional responsibility lies on the supervisors as they did not have enough information on the background and structure of the "innovative" new financial products, so they could not assess how big danger they posed on financial stability. It is interesting that hardly anything has been said about the responsibility of supervisors to date.

Thesis 3: Basel II proved unable to forecast and manage the financial crisis. The Solvency II system, still "under design", is to be rethought and harmonised with the most assuredly changing banking regulations.

Bank sector became the sector most gravely struck by the crisis. The central question for the present banking supervision is whether the bank has enough capital to cover its risks. During regulation and supervision, the most important goal is to protect depositors' money as bank accounts are practically considered risk-free investment. With the spread of household mortgage-based financing, the institute of securitisation has gradually obtained a greater role. In this case the risks of credit provision are partly or completely transferred to the capital market investor.

The presently applied supervisory methods did not prove suitable to manage risks and enforce rules. Banks got further and further from prudent operation, while supervisors did not follow financial products, which went through a booming development. A central element of prudential regulation is capital control, the essence of which is that it stipulates a capital level with which the risks taken by the bank only endanger the owner's money. Even in the classical banking model, it was customary that banks sold part of the credit risks securitised outside the banking system; however, it did not belong to the basic activities of banks then. As time passed, this kind of activity went through a significant "development" and its power and weight far exceeded every expectation.

Unfortunately, the 2006 introduction of Basel II failed to bring anything new into supervision from this aspect as the realisation and regulation of special risks both failed to take place. Therefore, Basel II is incapable of covering the potential losses occurring along realistic assessment, which is why the Basel Committee should rethink its recommendation. However, it has to be added that the traditional banking risk management practices also failed to provide appropriate protection and ensure prudent operation.

It is formulated as an expected requirement that, in order to ensure the consistence of the entire financial sector, the Solvency II system will have to be harmonised with the regulations applied in the area of banking as necessary. Products containing similar risks could in theory be supervised the same way and the same capital or solvency requirements should apply to them. If the new control is implemented in the domestic laws, it will solve one of the most significant supervisory deficiencies, namely that the fusion of a bank and an insurer is not solved from the aspect of accountancy and capital requirements.

Thesis 4: Enforcement of the regulations introduced to regulate and supervise the financial institutions should receive much more emphasis. The solution could be the introduction of an international supervisory organisation, free from interests and the influence of the market players.

One of the most important steps in order to maintain financial stability would be the enforcement of the existing regulation elements. Consistently applied regulatory measures and those facilitating the financial stability could have significantly reduced the damages caused by the crisis. Country borders no longer stop the spreading of financial institutes and financial products. Therefore, it would be worthwhile to bring the otherwise developed and modern supervisory authorities under the control of a newly established world supervision. Thus it would be possible to perfectly integrate regulation and supervisory procedures on a global level. So the technical and legal system of terms was available but the enforcement of the competences failed to take place. Prudent operation would be ensured again by establishing a world supervision authority that would be beyond the supervisors of the individual states, unifying all of them.

4. UTILISATION OPPORTUNITIES OF THE DISSERTATION

- the author of the dissertation primarily summarised the Hungarian characteristics and development phases of the money and capital market control, which is intended to help the continuous scientific development of the researched field
- the dissertation aims to realise both comprehensive, systematising and problem-solving tasks
- the formulated theses are intended to offer assistance in the work of the domestic supervisory organisations, as well as in elaboration of the medium-term regulatory and supervisory strategy
- the problems raised in the dissertation may pave the way for further research activities.

5. PUBLICATIONS

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