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ECONOMY & FINANCE

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A COMPARATIVE STUDY OF STRATEGIES SUITABLE FOR HEDGING THE FOREIGN EXCHANGE RATE RISK OF A BIG COMPANY

Gyula Főglein – Zoltán Zéman – László Pataki[1]

ABSTRACT

As a result of the internationalization of the economy, foreign exchange transactions and, in this context, risks related to changes in foreign exchange rates appear in the lives of more and more businesses. Ignoring these risks or managing them inappropriately can also impair the company's ability to generate income, and even cause serious - in some cases unsolvable - liquidity disturbances. In our study, starting from the example of a large domestic company, we examined different strategies for hedging foreign exchange exposure. Due to length limits, we did not have the opportunity to present all possible strategies, but in relation to the hedging strategies we examined, we tried to reveal their possible advantages, dangers, and cost implications. We did all this in order to find the optimal hedging strategy/strategies for the company. During our investigation, we requested offers from 6 financial institutions. The level of the exchange rate to be protected was set at EUR/HUF 410.00. We found that, in the current market conditions, out of the four transactions we examined, three transactions (the forward, the zero-cost collar strategy and the participating forward) can be supported from the company's point of view.

JEL codes: G32, G17

Keywords: foreign exchange rate risk, foreign exchange forward transaction, plain vanilla transaction, zero-cost collar strategy, participating forward, profit-loss function

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1 INTRODUCTION

The last few years have triggered a series of economic shocks due to the pandemic and then the war that broke out in February 2022, which created an extremely volatile market environment. In a volatile market environment, plannability, which can be influenced by many external factors, becomes of primary importance for businesses. One of the most significant risks is currency risk. Currency risk includes:

- transaction risk, i.e. the price-based effect of exchange rate changes on foreign receivables and payables;
- economic or business risk related to the impact of exchange rate changes; and
- the revaluation or exchange risk that arises when the bank's foreign currency positions are revalued in domestic currency (*Van Greuning–Brajovic Bratanovic*, 2020).

Among these risks - from the point of view of our study - one of the most significant is the foreign exchange rate risk. Understanding how currency fluctuations can affect a company's performance is a complex task.

In a macroeconomic approach, the change of exchange rates is primarily determined by the change of the given country's export-import balance and its balance supplemented by income (i.e., the current account balance). In case of a negative balance, the deficit must be financed by a kind of capital flow. The economy is forced to raise funds (*Bélyácz*, 2013).

Permanently negative current account balances can typically be financed by working capital or debt-type investments. In order for the financing to be realized, it is primarily necessary for the given currency to have a high capital-attracting capacity, and this can be achieved by making investments in the given currency attractive to investors. This can be reach principally with a higher yield. Therefore, a currency can become attractive to investors if it exceeds the level of return available for other currencies with a similar risk, and for the given investor, the excess return available compensates for the risks arising in connection with the investment (K&H Treasury market risk management guide, 2015).

In the case of a given country, the main indicator of risk is represented by the CDS (Credit Default Swap) value of the given country. CDS, in short, credit default swap, can be considered as insurance against the insolvency of a country. It is of great importance for international investors, as it helps them distinguish risky countries from less risky countries. Due to CDS, they can predict the risk of a given country not being able to repay its public debt. The higher this value, the riskier the given country (*Brealey–Myers*, 2011).

Examining the effect of exchange rates from a microeconomic point of view, exchange rate fluctuations have a significant impact on the sales revenue and profitability of companies. If a company does not protect itself against the volatility of exchange rates, it is exposed to this risk and, in certain cases, not only its profitability, but even the future of the company may be at stake (*Collins*, 1999). Filtering out currency exchange movements that distort the company's earnings is a significant challenge for financial professionals (www.pwc.com).

Foreign exchange rate risk occurs in companies whose revenue or expenses are realized in a currency other than HUF, or whose HUF-based revenue/expenses are determined depending on another currency, and which have foreign currency loans, or pay or receive dividends in other currencies (*Bleuel*, 2008).

We can speak of an open foreign currency position if a given company carries out an activity in connection with which its foreign currency exposure arises. Depending on whether it is hedged, this currency exposure can be either open (unhedged), or hedged. In the case of hedged currency exposure, there is revenue behind the payment, and against the revenue, we can find a payment in the liquidity plan at approximately the same time, in the same period, in a similar amount within the same currency, or the exposure has already been hedged with a transaction (*Reichardt*, 1997).

Measuring and managing exposure to exchange rate risk is important to reduce companies' vulnerability to significant exchange rate movements that can adversely affect profit margins and asset values (*Papaioannu*, 2006).

In an open economy like Hungary's, sooner or later every business is faced with exchange rate risk. Since exchange rate fluctuations can significantly affect goodwill and profitability, the company's senior management must pay extra attention to the management of exchange rate risk.

Exchange rate risk related to companies' foreign exchange transactions can be handled professionally and unprofessionally, but ignoring the supervision of exchange rates can have serious consequences (*DeRosa*, 2006).

Unprofessional exchange risk management can cause a foreign exchange loss of HUF 50–100 million (minus 1-2 percent) per year for a company with export revenues of HUF five billion, while the treasurer of a company that manages exchange rate risk in a professional manner realises exchange gains of HUF fifty million from banking transactions every year (plus 1 percent) (*Jenei*, 2020).

Foreign exchange hedging strategies involve the elimination or reduction of this risk and require an understanding of how exchange rate risk can affect the operations of economic operators and techniques to manage the resulting risk effects (*Barton*, *Shenkir* and *Walker*, 2002).

The majority of companies think along conservative risk management principles, with the goal of eliminating exchange rate risk. The most prudent approach is if the internal regulations state that all exchange rate risks shall be eliminated immediately as soon as they arise. The attitude which prohibits the assumption of new risks, but allows flexibility in the timing of the closing of foreign currency positions arising in the course of normal business activity, and does not prescribe the obligation of immediate closing is slightly more permissive than the aforementioned approach.

How can a specific currency risk be hedged? Basically, the solutions can be classified into two groups: the so-called **natural hedge** or the use of **financial instruments**. Natural hedging can be, for example, when my purchases and sales are matched in terms of currency risk, in the same currency, thereby creating two opposite currency risks for the same period, which neutralize each other. In such a case, the company has foreign exchange transactions, but does not have an open position yet (*Coyle*, 2020; *Henderson*, 2006).

In the case of derivative instruments, a treasury pursuing a conservative exchange rate hedging policy can only enter into currency spot and forward transactions, or possibly standard currency option transactions. The more complex and exotic product we want to use, the more speculative elements will be in the hedging and the more uncertain the final outcome will be. That is why it is important to define the operational risk manager's scope (*Szabó*, 2022).

Whether a company hedges its open currency position, as well as with what instruments and to what extent, shall always be laid down in the internal regulations of the given company, taking into account the company's willingness to take risks. Based on their willingness to take risks, market participants can be classified into three groups:

- Risk averse: "Businesses that follow risk-averse behaviour strive to completely eliminate risks and dangers in connection with their business goals and actions."
- Risk-reducing: "Following a risk reduction strategy means that the company faces the emerging risks and takes the necessary measures in order to mitigate and prevent possible damage." (*Szőrös–Kresalek*, 2010)
- Risk-sharing or risk-transferring: a company exhibits risk-neutral behaviour if these risks do not play a prominent role in the life of the company, either because the company occupies such a strong position in the given market, or the risks are so small that they do not affect the company's result perceptibly (Szőrös–Kresalek, 2010).

2 MATERIAL AND METHOD

We would like to present the management of foreign exchange rate risks through the example of a large company, which clearly illustrates the effects, risks, advantages and value of hedging strategies.

As far as the core activity of the large company in our example is concerned, the company primarily deals with the manufacturing of products for the commodity market. In connection with the company's activities, a significant part of the raw materials and auxiliary materials required for product manufacturing is procured from abroad. The manufactured products are typically sold in Hungary, in the domestic market, therefore a significant part of the sales revenue is realized in HUF. Considering that in the case of the company, we are talking about foreign procurement (given in euros), payment positions (payments) in euros arise against mostly revenues in HUF.

Examining the company's liquidity plans, it is clear that, as a result of the company's activities, a significant euro short position is created against the forint's long position (purchases and payments are made in euros, but the company's revenue is realized in forints). In order to hedge its open currency position, the company needs to buy euros from forints, therefore it has to sell forints and buy euros. As a result, the company can hedge its exposure with a EUR/HUF sell transaction, thereby protecting itself against unfavourable movements in the EUR/HUF exchange rate.

By means of the transactions, our company is able to eliminate the possible exchange rate losses that may be suffered in connection with individual exchange rate movements. In addition, the hedged positions contribute to the fact that the exchange rate level for the realization of the transaction can be determined well in advance, therefore due to the hedge, we can get an accurate point of reference for planning and calculation of costs.

Based on the analysis of the liquidity plan for Q3 of 2022, it can be established on the euro side that a short position of EUR 10 million will emerge in connection with the operation of the company.

With regard to the fact that our company does not have any kind of revolving credit facility, without intervention the company is forced to face a collateral shortfall on the euro side.

Another important piece of information is the fact that the company aims to protect a predetermined exchange rate level (the planned exchange rate included in its business plan), so that the company should not be forced to suffer a loss compared to the planned exchange rate / target exchange rate due to foreign currency

exposure, and this financial loss should not negatively affect the realization of its plans. The level of the exchange rate to be hedged was set at EUR/HUF 410.00.

In the next part of our study, we present banking instruments that can be used to manage the risks arising from the volatility of the foreign exchange rate in connection with the aforementioned open foreign exchange position and the foreign currency exposures of the large company in the example, and we detail the advantages, risks, and possible outcomes related to these transactions. Hereunder, we examine the following transaction types: foreign exchange forward transaction, plain vanilla option, participating forward transaction, zero-cost collar.

Request for data required for the development of a hedging strategy:

In order to hedge the open currency exposure, our company requested offers from its banks for the four transactions according to the request for proposal below. In order to get an accurate market picture of coverage options and exchange rates, it is worth sending the request for data to as many, if possible, all banks of the company.

Table 1
Data request for banks

	Amount (in M EUR)	Type	Pair	Side	Delivery	Spot ref.	Swap	Rate
Bank name	10.000	FWD	EURHUF	buy	01/09/2022			

	Amount (in M EUR)	Type	Pair	Ref.	Type	Expiry	Delivery	Price (in %)
Bank name	10.000	LC	EURHUF	ATMF @ 402.30	European	30/08/2022	01/09/2022	

	Amount (in M EUR)	Type	Pair	Side	Expiry	Delivery	Spot ref.	Swap	Rate
Bank name	10.000	Part FWD	EURHUF	buy	30/08/2022	01/09/2022			

	Amount (in M EUR)	Type	Pair	Expiry	Delivery	SP	LC
Bank name	10.000	ZCC	EURHUF	30/08/2022	01/09/2022		410.00

Source: own editing based on the data received from the banks

In order to price the hedging by the banks, the exact parameters of the hedging transactions must be specified. The information required to be provided by the banks is indicated by the grey cells. In the case of a forward (forward, hereinafter referred to as: FWD) transaction, the amount, the currency pair, the direction of the transaction and the maturity date are essential data for banks. In the case of an FWD, it is important to know the spot reference data, as the starting basis of the foreign exchange forward transaction, as well as the swap points, which show the pricing of each bank. The forward price is the sum of the latter two figures.

When hedging with an option transaction, in addition to the data used for the FWD transaction, it is important to specify the type of transaction for pricing, in

our case: buying the right to buy (Long Call – LC), based on which the bank can identify the nature of the hedging. In our case, we want to buy a right (to buy) in exchange for an option premium at the level of the forward exchange rate (this is the so-called „at the money forward" – i.e. ATMF). When pricing the LC option, the fact that we want to buy a European option (i.e. the creation of the right contained in the option transaction is only examined at the specified maturity) carries additional important information for the bank.

In the case of the participating FWD strategy, it is necessary to start off the same data and we would like to receive in the same data from the bank as in the case of the FWD transaction, however, due to the nature of the transaction (a right of 50% in our case) and the resulting pricing methodology, we should receive different data.

In the case of the fourth and last examined transaction type – the zero-cost collar (ZCC) – we can speak of a complex option transaction, where two opposite option transactions are concluded (we buy one option and write a call option right, therefore we sell), so that the premiums of the two options should be the same, thus creating a zero-cost option transaction. In this case, we look for the level of the option right that we have written (Short Call – SC), where the level of the premium is the same as the level of the option premium of the right we want to buy (LC). The level of the option right we bought (LC) must be matched to the level we want to protect (EUR/HUF 410.00).

When developing the hedging strategy, we requested offers from six banks for each type of transaction. This relatively large number of offers can ensure that our company gets an accurate picture of market levels and exchange rates. If we only request a bid from one or a maximum of two banks, we may even get a distorted picture compared to the current levels and bids in the market.

The Bloomberg/Reuters interface can also serve as an additional indication of market levels, where real and current spot market rates can be easily monitored and checked.

3 ANALYSIS OF CURRENT MARKET LEVELS WHEN EXAMINING THE HEDGING STRATEGY

In connection with the development of hedging for the risk strategy arising from the volatility of foreign exchange rates, the first step is to examine the current market rates. By means of the Bloomberg/Reuters interface, the change in the EUR/HUF exchange rate for approximately the past year was retrieved, which is shown in *Figure 1.* In relation to the foreign exchange rates of the past year, it can be said that the exchange rate levels were scattered between EUR/HUF 347.00

and 398.50, which corresponded to a range of HUF 51.50, 12.92% in the examined period. In terms of one year, this exchange rate fluctuation can be called very significant. The forint has weakened a lot during this time. *Figure 1* clearly shows the weakening of the forint caused by the Russian-Ukrainian conflict since the end of February.

Based on the Bloomberg report retrieved when examining the possibility of the hedging strategy, it can be said that the average spot exchange rate in the market at the time of the query (1 June 2022) was EUR/HUF 396.00, which was HUF 14.00 more favourable per euro than the EUR/HUF 410.00 exchange rate level to be hedged.

Figure 1
EUR/HUF Table 15.06.2021 – 10.06.2022

Source: Bloomberg „EURHUF" Table

3.1 Presentation and analysis of foreign exchange rate hedging strategies

In the case of spot transactions, the parties are obliged to settle with each other already on the day T + 2, or on the day when the transaction is concluded, i.e. the two currencies participating in the transaction are already mandatorily exchanged between the parties (therefore the CF effect already arises). Based on our company's liquidity plans, the necessary hedge is not available when creating the hedging strategy, therefore the company cannot hedge its open position by means of these transactions, which is why the exchange rate risk management with the above-mentioned two strategies was rejected.

The possibility of hedging with a spot transaction at the maturity date of the open position (01.09.2022) was also rejected, because the purpose of the hedging strategy is to secure the desired exchange rate, i.e. to close the transaction. Hedging upon maturity involves leaving the transaction open until the maturity date.

3.2 Foreign exchange forward transaction

In contrast to the prompt and spot transactions detailed earlier, we have the opportunity to conclude a forward transaction precisely adjusted to the day on which the currency demand arises, therefore, in contrast to spot and prompt transactions, the hedge must only be available to the parties at the maturity date of the concluded forward transaction. After checking the company's liquidity plan, we can establish that it is possible to conclude a forward transaction, since the forint hedge is available upon maturity due to the revenues.

Our company received the following forward EUR/HUF buy offers (examining the direction of hedging from the company's side) from its banks, with a maturity date of 1 September 2022:

Table 2
Bank offers requested in connection with the FWD transaction

	Amount (in M EUR)	Type	Pair	Side	Lejárat	Spot ref.	Swap	Rate
Bank 1	10.000	FWD	EURHUF	buy	01/09/2022	396.00	635.00	402.35
Bank 2	10.000	FWD	EURHUF	buy	01/09/2022	396.04	676.00	402.80
Bank 3	10.000	FWD	EURHUF	buy	01/09/2022	396.00	630.00	402.30
Bank 4	10.000	FWD	EURHUF	buy	01/09/2022	396.10	662.00	402.72
Bank 5	10.000	FWD	EURHUF	buy	01/09/2022	396.15	797.00	404.12
Bank 6	10.000	FWD	EURHUF	buy	01/09/2022	396.09	692.00	403.010

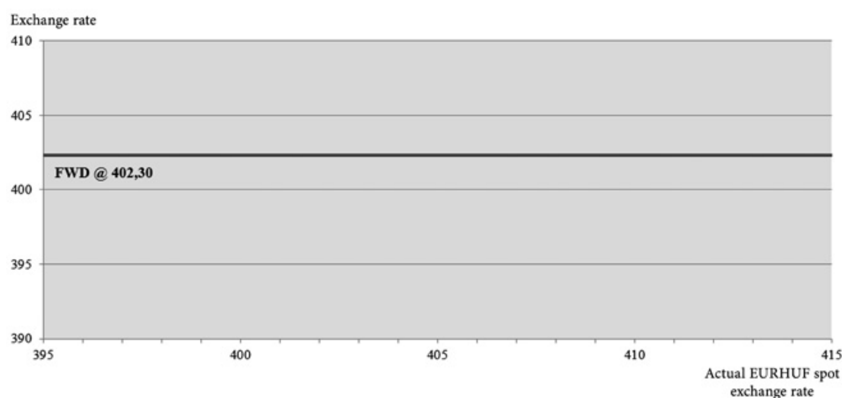
Source: own editing based on the offers received from the banks

After examining the offers received from the six banks, Bank 3 gave the most favourable offer at a level of EUR/HUF 402.30 to hedge the exposure EUR 10 million. The highest offer, expressed in forints, provides hedging at a level higher by HUF 18.2 million than the most favourable level of EUR/HUF 402.30. The quotations of Bank 3 and Bank 1 were based on the lowest reference spot quotation, while the highest value was given by Bank 5 in this case, as well. Bank 6 quoted with the lowest margin, however, due to the average spot reference level, it could not „beat" its competitors with its price.

The exchange rate level given by Bank 3 means that our company is protected at EUR/HUF 402.30 in the event of a transaction, therefore the cost calculated in HUF to hedge the EUR 10 million exposure amounts to a total of HUF 4.023 billion. This level provides protection at a level which is lower by 7.70 forints than the target rate per euro (in terms of the total exposure, this corresponds to a level lower by 77 million forints).

Similar to the spot transaction, the forward transaction is also a mandatory transaction, therefore both parties shall fulfil their obligations during the transaction. This means that regardless of the exchange rate levels on the market at maturity, both parties shall ensure the smooth implementation of currency exchanges between the parties. As a result, at any current spot market level, the transaction will be realized at the level of EUR/HUF 402.30 included in the bank's offer, which is shown in *Figure 2*.

Figure 2
The exchange rate values of FWD
reflected by the spot market exchange rates valid at maturity



Source: own editing

In *Figure 2*, the vertical axis shows the values of the FWD transaction for each market spot exchange rate (moving along the horizontal axis). The figure clearly illustrates that, due to the mandatory nature of the transaction, the price of the concluded FWD transaction cannot be affected by market processes, i.e. at any spot EUR/HUF exchange rate, the transaction is concluded at the level of 402.30 at maturity. In view of the above, the following statement is true: despite movements in the exchange rate into unfavourable direction, the FWD strategy protects against possible losses, but does not allow participation in favourable market movements.

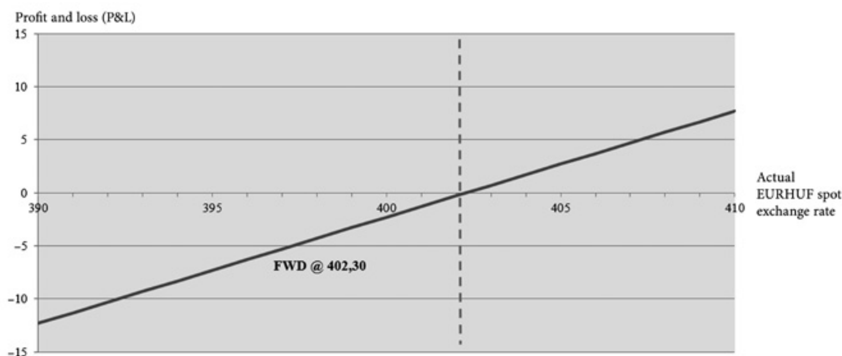
With the foreign exchange forward transaction, the exchange rate of the transaction is a known and guaranteed factor, therefore, in our case, all the costs related to the purchase of foreign currency are known in advance. During planning, the company is able to calculate with this factor, and the exchange rate level at which the necessary amount of foreign currency is purchased is guaranteed to us in advance at the level of EUR/HUF 402.30.

Figure 3 shows the P&L function of the FWD transaction, which can be used to determine the MtM (Marked to Market) value of the transaction at any time. The vertical axis indicates the profit or loss achieved on the transaction for the given spot market exchange rate value. Based on this, it can be concluded that if the current spot market rate is EUR/HUF 402.30, then the current MtM value is exactly zero, i.e. neither loss nor profit is generated on the transaction compared to the market level.

If the spot price is lower than the level of 402.30 at the time of the investigation, our company is forced to record a loss, because if the position had not been hedged with the FWD transaction, the company would be able to hedge its open exposure cheaper in the market at the current level. Assuming a current spot level of EUR/HUF 400.30, this means a loss of HUF 2 per euro, i.e. a loss of HUF 20 million is possible based on the example, in terms of the full exposure. Every decrease of HUF 1 in the exchange rate below the level of EUR/HUF 402.30 causes an additional loss of HUF 1 per euro (calculated for the total exposure of HUF 10 million). If this scenario comes true, our company's foreign exchange rate expectations were not correct, the exchange rate level moved in an unfavourable direction for the company.

The MtM value is positive, therefore the company makes a profit with the transaction if the current exchange rate is above EUR/HUF 402.30 at the time of the investigation or at maturity. In this case, if the hedging exchange rate level is exceeded by the exchange rate value, for each 1HUF increase (weakening forint or strengthening euro), a profit of HUF 10 million is generated on the exposure compared to the market level. This means that the EUR/HUF exchange rate changed in accordance with the company's expectations, the company hedged its short currency position properly, and its hedging strategy was well-formed, because the company protected itself against unfavourable movements and realized a profit against the market on the transaction.

Figure 3
The profit-loss function of the FWD transaction in the context of the spot price valid at maturity



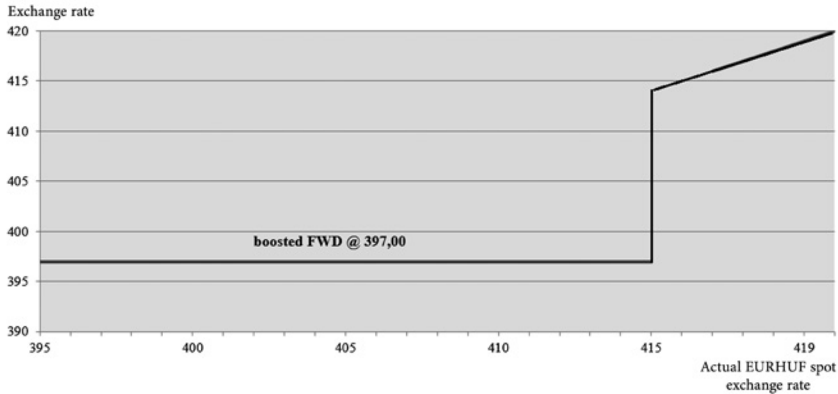
Source: own editing

As an additional option, we also examined the possibility of transforming the forward transaction so that the basic FWD transaction is supplemented with a knock out (KO) level, as a result of which the forward price can be made more favourable. In the case of the above transaction, an additional exchange rate level (KO level) above the exchange rate to be protected is determined, thereby our company may face two scenarios regarding the outcome of the transaction: i) as long as the market spot rate does not reach the KO level at maturity, the currency exchange between the parties is settled at a (boosted – more favourable, boosted) forward price, but ii) if the spot market level reaches or exceeds the KO level, our forward transaction is terminated (knocked out) and the exposure becomes open again. From our point of view, the main risk of the transaction is that, in the latter case, our company will be forced to purchase euros again at the market level, which will certainly be higher than the set target rate of exchange, but until the KO level is reached, the forward transaction will be realized at a level that is more favourable level for us.

For the EUR/HUF 415.00 KO level, the EUR/HUF 397.00 forward price was the best bank offer. In this case, up to EUR/HUF 415.00, our company will receive euros at a forward price of EUR/HUF 397.00, while above EUR/HUF 415.00 spot, the transaction will be terminated and above EUR/HUF 415.00 we will be forced to purchase euros.

Figure 4 shows the effect of reaching the KO level: if the spot market level reaches the KO level (EUR/HUF 415.00), the deal will be terminated and our company will be forced to purchase euros again at market levels.

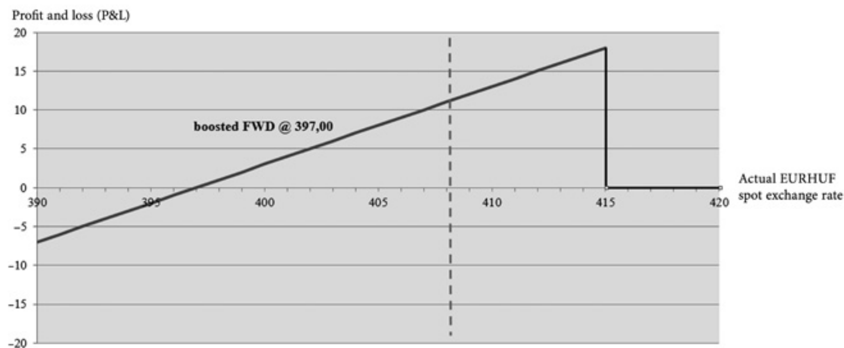
Figure 4
The exchange rate values of the boosted FWD reflected by the spot market exchange rates valid at maturity



Source: own editing

The profit-loss function of the boosted FWD transaction also reflects our statement above, according to which the MtM value will continuously increase our profit against the market above EUR/HUF 397.00 until reaching the KO level, however, upon reaching EUR/HUF 415.00 (KO level), the MtM value will drop to zero. The MtM here will be zero, however only against the market spot rate, but from then on, our company will be forced to purchase the necessary euros in the market at levels above EUR/HUF 415.00, which, on the one hand, will cause a loss to FWD , and on the other hand, exchange rates above the target rate will be realised.

Figure 5
The profit-loss function of the boosted FWD transaction in the context of the spot price valid at maturity



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As a second possibility, we examined what would happen if our company wanted to enter into a forward transaction involving the EUR/HUF 435.00 KO level. In this case, the (boosted) FWD transaction could have been concluded at EUR/HUF 401.00. In the latter facility, when the strategy was created, it allowed a volatility of HUF 25 (6.31%) above the target rate of exchange and HUF 39 (9.85%) above the current spot price (on the side of the weakening forint) until the knock-out level was reached. The strategy provides an opportunity to buy euros at a level that is HUF 9 lower than the target rate (HUF 90 million for the entire transaction) and HUF 1.30 lower than the normal forward rate (total hedging cost HUF 13 million).

3.3 Plain vanilla option

When concluding a plain vanilla options transaction, one party sells (or buys) an option obligation to (from) the other party, while the other party in the transaction buys (or sells) an option right against the other party. In this case, the party writing the option receives an option fee (premium), while the buyer of the option pays an option premium to the issuing party, regardless of whether the party holding the option right will exercise it (in the future), i.e. whether the transaction is called or not . In all cases, the option premium shall be paid upon conclusion of the transaction. If the buyer of the option right asserts his right – i.e. exercises their option right – the other party will always have an obligation written in the option.

Since the origination of the option right is determined in every case in such a way that the buyer of the option wants to protect themselves from levels that are less favourable than that, it can be definitely stated that if the buyer does not have the right to exercise the option, the net price of the transaction will always be more favourable than the target rate of exchange.

Considering that in our case the open foreign currency position of our company is short, i.e. foreign currency purchase is necessary, we will therefore further examine only the long call (LC) transaction type, since our company is only able to hedge its position with this type of transaction (it acquires the right to purchase, in the case of exchange rates above a certain level in the market, the required amount of foreign currency at the strike price, regardless of market levels).

In the case of a European-type option, the strike price is examined against the spot market levels valid at maturity only at maturity, while in the case of an American-type option, the exchange rate is examined during the entire term, i.e. in the period from the conclusion of the option to its maturity. Since the bank

has a significantly higher risk in the second case, the option premium is more expensive, i.e. higher.

As the most cost-effective strategy is an important factor for our company, we decided to further investigate the generally lower-cost European-style option strategy.

In accordance with the data request form of the option strategy, our company is looking for an option premium rate that provides it with a European-style call right (LC) with a given maturity (30/08/2022) and for a given amount (EUR 10 million) at the level of the ATMF (i.e. the forward price).

In connection with the data request for the purchase of the long call (LC), the banks gave offers as summarized in *Table 3*. The most unfavourable offer was given by Bank 3 at the level of 2.82%, while the most favourable offer came from Bank 1 at the level of 2.73%. The 2.73% option premium shall be understood and calculated for the total transaction value, i.e. the premium level of the ATMF LC intended to be tied to a liability of 10 million euros means a cost of 0.273 million euros (~110 million forints). There is a total difference of 90,000 euros between the premium of the best and the worst offers (this amounts to ~ HUF 36 million). In the case of our company, the premium fee of more than HUF 110 million means that this cost increases the EURHUF exchange rate per one euro by HUF 11.00, i.e. actual protection – including the level of the strike price (402.30) and the premium projected per euro cost (11.00) – can be realized at a total level of EURHUF 413.30, which is HUF 110 million higher than the option for forward currency purchase.

Table 3
Bank offers requested in connection with the LC transaction

	Amount (in M EUR)	Type	Pair	Ref.	Type	Expiry	Delivery	Price (in %)
Bank 1	10.000	LC	EURHUF	ATMF @ 402.30	European	30/08/2022	01/09/2022	**2.73**
Bank 2	10.000	LC	EURHUF	ATMF @ 402.30	European	30/08/2022	01/09/2022	2.79
Bank 3	10.000	LC	EURHUF	ATMF @ 402.30	European	30/08/2022	01/09/2022	2.82
Bank 4	10.000	LC	EURHUF	ATMF @ 402.30	European	30/08/2022	01/09/2022	2.735
Bank 5	10.000	LC	EURHUF	ATMF @ 402.30	European	30/08/2022	01/09/2022	2.75
Bank 6	10.000	LC	EURHUF	ATMF @ 402.30	European	30/08/2022	01/09/2022	2.80

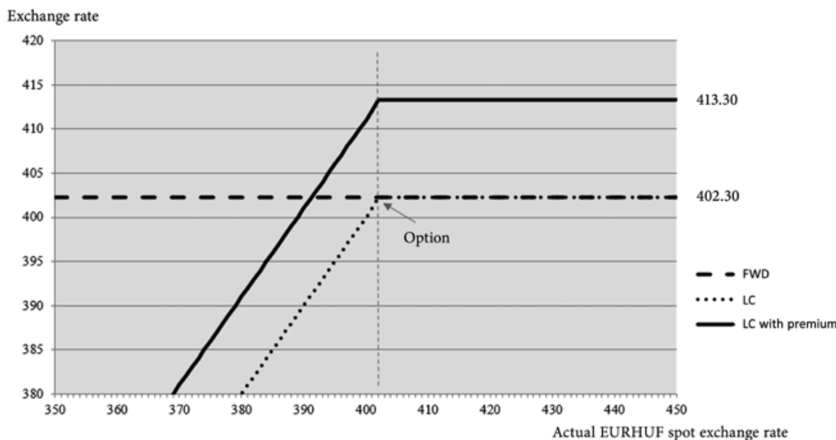
Source: own editing

On the basis of the requested best bank offer, the exchange values of the plain vanilla transaction are represented in *Figure 6* in the light of the spot market exchange rates due at maturity. The vertical axis shows the values the price of a

simple option transaction can take for each market spot exchange rate (moving along the horizontal axis).

The characteristic of the LC transaction is that as long as the transaction takes place in the market (in our case, the purchase of euros), the party with the option right does not exercise and shall not be entitled to exercise their the option right. Based on the above, until the market exchange rate reaches EUR/HUF 402.30, our company can hedge at current market level. If the market level reaches or exceeds the EUR/HUF 402.30 level at the expiry date, the rights included in the option can be exercised, i.e. in the case of any market rate above the 402.30 exchange rate level, our company has the opportunity to buy euros against forints at the 402.30 level. If we also take into account the premium per euro paid when buying the option and interpret it in a gross way (examining the entire exchange rate paid for one euro), the actual protection is realized at EUR/HUF 413.30 (above the target rate of exchange!) as shown in the figure.

Figure 6
The exchange rate values of the plain vanilla transaction reflected by the spot market exchange rate due at maturity

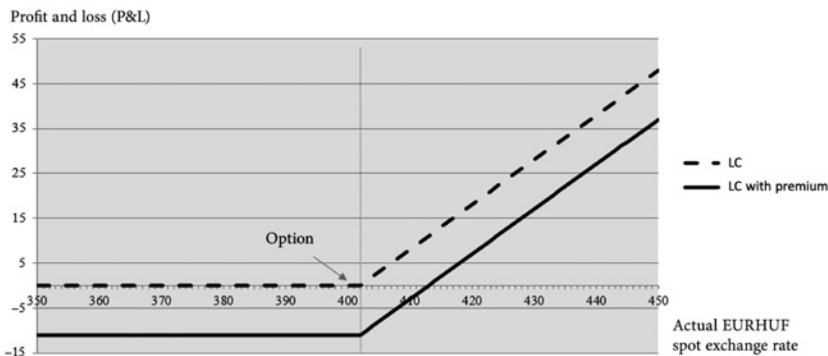


Source: own editing

Figure 7 shows the P&L function of the plain vanilla deal (vertical axis) for the current market rates shown on the horizontal axis, which can be used to determine the MtM value of the transaction at any time/date. Based on the profit-loss function of the simple option transaction, it can be said that as long as our company does not exercise its option right, it makes neither a profit nor a loss on the transaction compared to the market levels (it cannot, since the euro is purchased

in the market). If the company is able to assert its right included in the option at maturity (in the event that the exchange rate exceeds EUR/HUF 402.30 at maturity), the hedge will turn into profit. Every HUF 1 increase in the spot exchange rate at maturity results in a profit of HUF 1 per euro, i.e. HUF 10 million in relation to the total transaction amount of EUR 10 million. From the point of view of our company, the effect of the option premium pushes the profit-loss function in the direction of loss by HUF 11 per euro, i.e. the strategy actually turns into profit above EUR/HUF 413.30.

Figure 7
The profit-loss function of the plain vanilla transaction in the context of the spot price valid at maturity



Source: own editing

In view of the above, the possibility of whether there is an LC level where the total value of the call rate and the premium per one euro does not exceed EUR/HUF 410.00 was examined. Since the strike price of EUR/HUF 402.30 and the current spot market exchange rate (EUR/HUF 396.00) at the time of the development of the hedging strategy were very close (within 1.6%). Consequently, there was practically no exchange rate level available in the market at which it would have been possible to achieve the above correlation, because for this an in-the-money (ITM), i.e. a (profitable) option with an intrinsic value at the time of the conclusion, would have had to be entered into. Taking into account the impact of the premium per euro received at the ATMF (11 forints per euro), the target rate of exchange of EUR/HUF 410.00 could have been protected at a strike price of EUR/HUF 399.00. Considering that the more ITM an option is, the higher the premium will be, therefore the more we lower our strike price, the more option premium will be added. As a result, the HUF exchange rate will not be able to

strengthen below the EUR/HUF 410.00 level, therefore we can state that the designated target rate of exchange cannot be hedged with an option right.

Both in *Figures 6* and *7*, we can observe the previously mentioned paradox related to option transactions, that the company is in a favourable position if it does not have to call the option from its bank, despite the fact that the option premium was already paid when the transaction was concluded, as in this way, euros can be purchased at a level even lower than the strike price.

If we set the strike price of our purchased option to EUR/HUF 410.00, we would only be able to hedge the option transaction at the level of the target rate of exchange by examining the option transaction on its own, because a EUR/HUF 410.00 LC option creates a premium worth 2.09% (HUF 8.56), therefore overall protection is created at EUR/HUF 418.56, with which the target rate of exchange cannot be protected as a whole.

3.4 Zero cost option

In the case of a zero-cost option, two options are interpreted in the same direction (sell or buy) within a transaction. Concerning one „leg" of the transaction, we buy a right, while in the case of the other „leg" of the transaction, we will have an obligation (we sell a right). Given that in the case of this strategy, two option transactions are defined with the same maturity, amount and direction, we must speak of a complex option strategy.

In connection with the two options, it can be stated that since in the case of both „legs" one party will have the right to sell or buy, the exchange rate of the transaction concluded with the option cannot exceed these two extreme values, i.e. these two exchange rate values will be the maximum or minimum (exchange rate) output of the transaction. As a result, the zero-cost option strategy is also called a collar transaction, hence the English name Zero Cost Collar (ZCC).

The zero-cost collar option hedging strategy is a cost-free strategy from the point of view of both parties concluding the transaction (bank and client), because it consists of two option transactions in opposite directions (plain vanilla), so that the premiums of each option transaction are the same. In view of the above, the cost-freeness of the zero-cost collar transaction results from the fact that during the pricing, the right specified (written) by us (at a fixed exchange rate in this case) is accompanied by an option obligation (sold right) in the opposite direction for this right (exchange rate level), where the paid and the received option premiums are the same.

Since our company wants to protect itself from being forced to buy euros at levels above the target rate of exchange (EUR/HUF 410.00), we have set the long call

(LC) at the level of 410.00 – protecting the target rate. In the data request form, this level was referred to as the LC exchange rate (upper threshold level), for which the bank had to determine the lower threshold level (SP) where the premium of the two options is the same at the given (same) maturity.

Table 4 shows the offers given by the banks regarding the ZCC transaction. The best SP offer for the LC of EUR/HUF 410.00 (where the band is the widest – this way we have the opportunity to create the greatest room for manoeuvre while protecting the target rate of exchange) was given by Bank 2 with a level of EUR/HUF 398.00. The narrowest room for manoeuvre can be seen in the case of Bank 6, where the strategy protects against volatility of only HUF 10.00 per euro.

Table 4
Bank offers requested in connection with the ZCC transaction

	Amount (in M EUR)	Type	Pair	Expiry	Delivery	LC	SP
Bank 1	10.000	ZCC	EURHUF	30/08/2022	01/09/2022	410.00	398.12
Bank 2	10.000	ZCC	EURHUF	30/08/2022	01/09/2022	410.00	**398.00**
Bank 3	10.000	ZCC	EURHUF	30/08/2022	01/09/2022	410.00	398.355
Bank 4	10.000	ZCC	EURHUF	30/08/2022	01/09/2022	410.00	398.58
Bank 5	10.000	ZCC	EURHUF	30/08/2022	01/09/2022	410.00	399.10
Bank 6	10.000	ZCC	EURHUF	30/08/2022	01/09/2022	410.00	**400.00**

Source: own editing

Figure 8 illustrates the possible outcomes of the ZCC transaction:

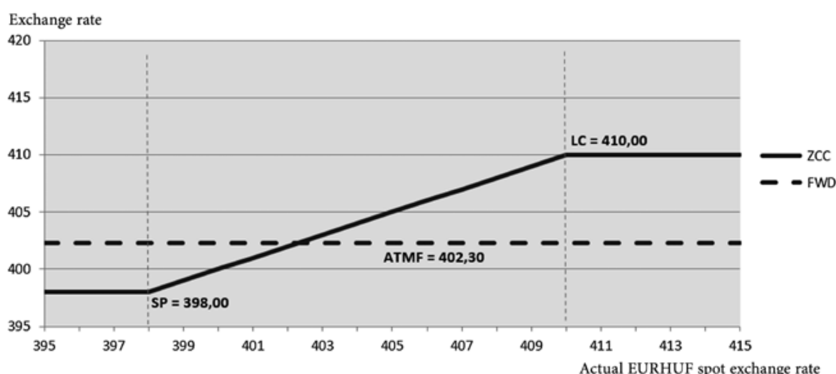
- If the spot exchange rate at maturity is above EUR/HUF 410.00, our company has the right to buy at the LC exchange rate (EUR/HUF 410.00 level). In the case of spot levels above the LC, the target exchange rate is protected, therefore there is no exchange rate loss against the target rate of exchange. With its weakening, the forint generates an exchange rate gain of one forint per euro for each movement by one forint in the EUR/HUF exchange rate compared to the spot exchange rate.
- If the spot exchange rate at maturity is between EUR/HUF 398.00 (SP) and 410.00 (LC), our company has neither the right nor the obligation to buy. The euro purchase transaction takes place in the market, at the spot exchange rate. Since the spot exchange rate in this case is definitely less than or equal to the target rate of exchange, no exchange rate loss can occur compared to either the target exchange rate, or the market levels, since settlement/transaction takes place at the spot exchange rate itself.

– If the spot exchange rate at maturity is below EUR/HUF 398.00, our company has a purchase obligation at the SP exchange rate (EUR/HUF 398.00 level). Below the short put level, the planned exchange rate is protected, there is no exchange rate loss against the target exchange rate, however, with the strengthening of the HUF, for each movement by one forint in the EUR/HUF exchange rate compared to the spot exchange rate, an exchange rate loss of one forint per euro occurs per EUR.

Figure 8 shows the reason why this strategy is called collar strategy: the exchange rate of the transaction cannot be higher than the exchange rate of the LC, and in the case of any spot market exchange rates below the exchange rate of the SP, the currency exchange will be carried out at least at the exchange rate of the SP. In the case of exchange rates above the call, our company exercises its right to buy, while in the case of exchange rates lower than the put, the bank exercises its right to sell, which in the case of our company will mean a purchase obligation.

The most favourable outcome for the company is (despite the fact that the MtM of the transaction is zero in this case) if the EUR/HUF market spot rate at maturity is 398.00, because in this case the purchase of the euro is realized at the lowest rate and our company does not have to suffer a loss compared to realisation at market levels.

Figure 8
The exchange rate values of the ZCC transaction reflected by the spot market exchange rates valid at the time of maturity

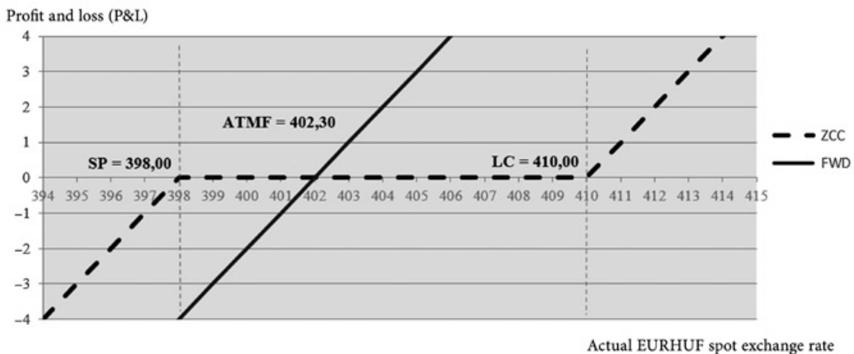


Source: own editing

Based on the profit-loss function of the ZCC transaction (Figure 9), it can be established that in the case of spot market levels between the SP and LC exchange rates, neither loss, nor profit arises, because between these two exchange rates,

neither party has a right that it can enforce against the other party. In the case of exchange rates lower than the SP value, loss is generated for the company in relation to the spot market rate at the time of maturity, while in the case of values above the LC, profit is generated.

Figure 9
The profit-loss function of the ZCC transaction in the context of the spot price valid at maturity



Source: own editing

A characteristic of the ZCC transaction is that the possible exchange rate values of the ZCC compared to the spot exchange rate at maturity, as well as the graph of the P&L function of the transaction, are the same as the separately drawn graphs of the SP and LC simple option transactions. The first half of the two graphs presented in the case of the ZCC transaction correspond exactly to individual graphs of the SP option, while the other half corresponds exactly to the identical graphs of the LC, so that the effects of the premium of the two options are on opposite sides. When examined separately, it improves the outcome of the transaction per euro in the case of SP (premium received), while in the case of LC (paid premium) it worsens the outcome. This also confirms the claim that the ZCC can consist of two opposing simple options, therefore their premiums extinguish each other.

From the perspective of hedging and the exchange rate to be hedged, when the hedging strategy was created, the ATMF exchange rate was very close to the exchange rate to be hedged. The SP exchange rate of LC EUR/HUF 410.00 was only HUF 4.30 away (this allows only 1.10% volatility), which squeezes the exchange rate of the possible outcome of the transaction into a very narrow band. This means that, from the company's point of view, the distance between the ATMF exchange rate and the purchase obligation exchange rate is 4.30 forints (398.00 vs. 402.30), i.e. the strategy allows for a 4.30 forint gain without creating a purchase

obligation, compared to the FWD strategy. This can be said to be favourable from the point of view that, compared to the FWD, our company can obtain the necessary euros at a level better by 4.30 forints, i.e. 43 million forints, in the case of the most favourable outcome. However, in the case of spot market rates below EUR/HUF 398.00, the company will be forced to record a loss against the market.

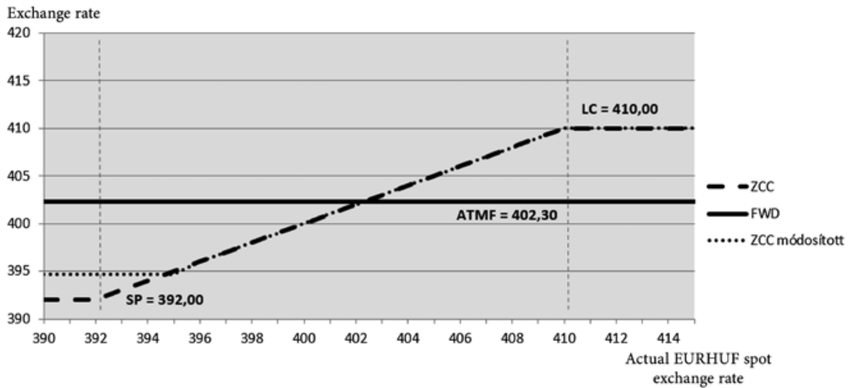
Extending the band of the collar to a wider range (moving the level at which the obligation arises further from the ATMF level) would, based on the logic detailed above, be only possible (the premium of the two options would be equal) if the LC exchange rate were raised to EUR/HUF 410.00. However, this would mean that the target exchange rate could not be protected, thereby the hedging strategy would become meaningless.

Due to the above, the restructuring of the ZCC strategy was examined as an additional option during the formation of the hedging strategy in order to enable favourable exchange rate movements in a wider range. Given that the level of LC cannot be set at a higher exchange rate due to the target rate of exchange, the possibility arose that the zero-cost option would be transformed into a complex strategy with a similar composition but with an option premium. With this, the price of the SP can be lowered (from EUR/HUF 398.00 to 392.00), but then – since the premium of the two options will no longer be the same – our company will be obliged to pay the option premium. Although the premium of this option will not be equal to the level of the premium of the plain vanilla option (because there is also a received premium against it, which covers the costs to a certain extent, represents compensation against the premium to be paid). Yet it would still have entailed a significant cost based on the banks' offer. The most favourable bank offer for LC 410.00 and SP 392.00 collar was 0.68%. In addition to the fact that this offer would still have provided protection in a very narrow band (a band of only HUF 18, i.e. 4.55%) band, given the current volatility, it had a very significant cost implication. The expected total cost of the strategy (premium) amounts to 68 thousand euros, 27.2 million forints in this case.

In accordance with the above, the image of the ZCC hedging transaction for the current spot market exchange rate will look like in *Figure 10*: in the case of levels below EUR/HUF 392.00, our company has a purchase obligation at the level of EUR/HUF 392.00, and in the case of levels above EUR/HUF 410.00, our company can exercise its long call at the level of EUR/HUF 410.00. In the case of spot market exchange rates between LC and SP, since neither party has any rights or obligations, the settlement takes place at the current market levels.

Taking into account the effect of the premium, the collar strategy can be realized with EUR/HUF 394.67 SP and EUR/HUF 412.67 LC options, i.e. in case of a call at the spot market price of EUR/HUF 410.00, it provides protection by HUF 2.67 above the target rate of exchange.

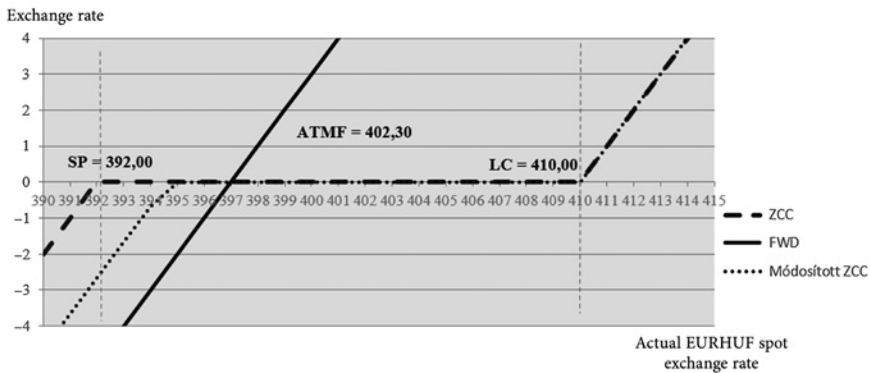
Figure 10
The exchange rate values of the modified ZCC transaction reflected by the spot market exchange rates valid at the time of maturity



Source: own editing

In the case of the modified ZCC transaction, according to Figure 11, our company incurs a loss at spot exchange rates below EUR/HUF 392.00, while at market levels above EUR/HUF 410.00, a profit arises due to the exercise of the long call. *Between the two levels of the ZCC strike price, neither party incurs a loss nor a profit compared to the market levels.*

Figure 11
The profit-loss function of the ZCC transaction in the context of the spot price valid at maturity



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3.5 Participating forward

The participating forward is a combination of the features of an option and a forward transaction. In general, we can say that a participating forward transaction is a complex option product in the nature of a forward contract, in the case of which we acquire the right to exchange one currency for another currency at a given exchange rate at a later date. If at a later date the market exchange rate is less favourable than the participating forward exchange rate, the entire agreed amount of currency will be converted, while if the market exchange rate is more favourable than the participating forward strike price, only half of the pre-agreed amount shall be compulsorily converted at the strike price. The remaining amount of foreign currency can be converted at the given market rate, i.e. the transaction allows you to share in the favourable market effects with the remaining portion of the total amount.

A participating FWD deal is very similar to a ZCC deal. In the case of the participating FWD, we can notice so many differences compared to a ZCC deal that the two extreme exchange rate values of the transaction (the put and call exchange rates) are determined not at different exchange rates, but at the same exchange rate value. However, we may rightly ask how the participating FWD transaction can be a cost-free transaction, if the levels of the right and the obligation included in the transaction are not separated, so that, in the case of our company, the right applies to the full amount, while the obligation only applies to a maximum of 50% of the total exposure. The answer is quite simple: when preparing the offer, the bank prices the risk that the transaction bears (the risk of the call) and it is to be paid by our company, as a client, not through the option premium, but the bank will determine the strike rate in such a way that it covers the inherent risks/riskiness of the transaction and the associated costs (over and above the cost of margin, operating costs and profit) against a FWD transaction. For the customer, this surplus appears in a strike price that is less favourable than the forward price.

Table 4 also proves our above statement. Among the six banks, the most favourable offer was given by Bank 3 with an offer of EUR/HUF 409.70. The exchange rate of the participating FWD transaction reflects the difference in pricing compared to FWD. For the forward period, we have the opportunity to conclude a transaction at the level of EUR/HUF 402.30, while our company can conclude a transaction at the level of EUR/HUF 409.70 with a participating forward transaction. The difference is HUF 7.40 per euro, which means that the strategy provides full protection at a HUF 74 million higher level (cost of full hedging: HUF 4.097 billion).

In the case of the requested bank offers, we can determine that the best rate of participating FWD is also very close to our target rate of EUR/HUF 410.00. With

the offer given by Bank 5, the hedgability of our target exchange rate is already in jeopardy.

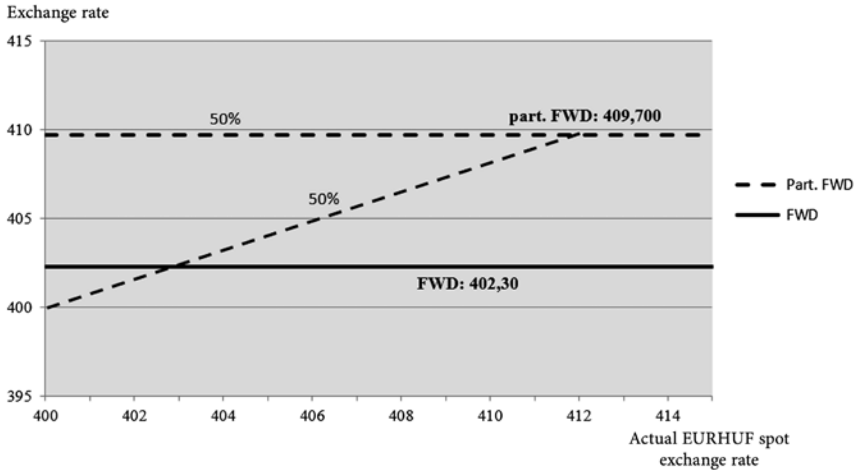
Table 5
Bank offers requested in connection with the participating FWD transaction

	Amount (in M EUR)	Type	Pair	Side	Expiry	Delivery	Spot ref.	SWAP	Rate
Bank 1	10.000	Part. FWD	EURHUF	buy	30/08/2022	01/09/2022	**396.00**	1 395.00	409.95
Bank 2	10.000	Part. FWD	EURHUF	buy	30/08/2022	01/09/2022	396.04	1 376.00	409.80
Bank 3	10.000	Part. FWD	EURHUF	buy	30/08/2022	01/09/2022	**396.00**	1 370.00	**409.70**
Bank4	10.000	Part. FWD	EURHUF	buy	30/08/2022	01/09/2022	396.10	1 375.50	409.855
Bank 5	10.000	Part. FWD	EURHUF	buy	30/08/2022	01/09/2022	**396.15**	1 404.00	**410.19**
Bank 6	10.000	Part. FWD	EURHUF	buy	30/08/2022	01/09/2022	396.09	1 383.00	409.92

Source: own editing

Considering that – as it is mentioned in the name of the participating forward transaction – we can talk about forward hedging to a certain extent, i.e. the transaction price is independent of the current market spot rates (see *Figure 12*). Regardless of what exchange rates develop in the market, our company will be able to buy euros at EUR/HUF 409.70. However, the exchange rates of the transaction need to be further investigated here. If the market exchange rate at maturity is above EUR/HUF 409.70, our company has the right (LC) to buy EUR 10 million at the level of 409.70, but if the exchange rate is below this level, only half of the total amount (liability) must be converted to euros (SP) at this level, while the remaining 5 million euros can be purchased on the market (i.e. at a more favourable level).

Figure 12
The exchange rate values of the participating FWD transaction reflected by the spot market exchange rates valid at the time of maturity



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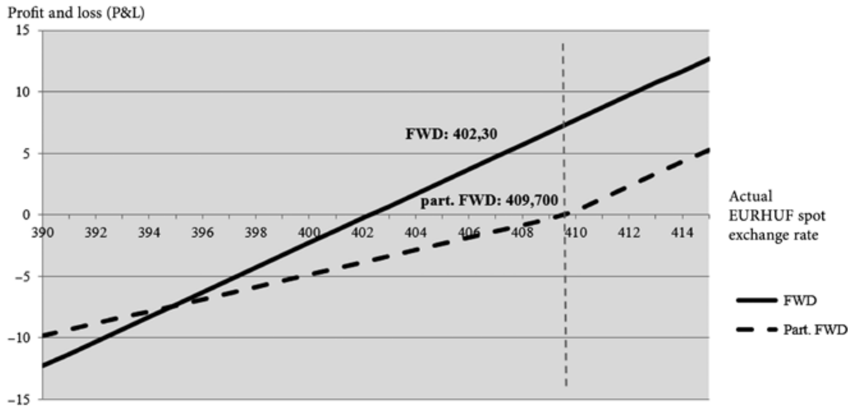
The profit-loss function presented in *Figure 13* can also be used to clearly perceive the enforcement of rights and obligations in connection with the transaction. In the case of levels above the EUR/HUF 409.70 level, our company has the right to purchase the entire amount at the EUR/HUF 409.70 level, therefore each EUR/HUF exchange rate level one forint higher than the strike price generates a profit of one forint per euro against the market. Below EUR/HUF 409.70, the function is half as steep as the plain FWD, because in the case of levels below 409.70, our company is only obliged to buy euros for half of the total amount at 409.70, while for the remaining 5 million euros, procurement takes place in the market. As a result, the appreciation of HUF by one forint below EUR/HUF 409.70 causes a loss of 0.5 forints (calculated for a total exposure of HUF 5 million) compared to if you did not hedge your open position and bought the required currency at maturity.

Figure 13
The profit-loss function of the participating FWD transaction in the context of the spot price valid at maturity



Source: own editing

On the basis of *Figure 13*, we can see that although the strategy offers a higher level of protection compared to FWD (but the target rate of exchange still remains protected), however, in the event of further strengthening of the HUF below the level of EUR/HUF 409.70, we can benefit from favourable exchange rates partially (by half of the total transaction value), i.e. we will have the opportunity to buy 5 million euros at 409.70 and another 5 million euros at the current market rate. In our case, if the exchange rate of the forint strengthens below EUR/HUF 395.00 against the euro, the company is already in a more favourable position than in the case of FWD, because the relationship between the loss function of the two transactions then turns in favour of the participating FWD (the loss suffered due to the transaction is already lower). Above EUR/HUF 395.00, however, we are better off with the FWD transaction.

4 CONCLUSIONS

Through the example of a large company, we examined the options for hedging its open foreign exchange rate exposure, with which the company can effectively manage the exchange rate risk arising in connection with its open position of 10 million euros in the Q3 period of 2022. **In the case of individual hedging transactions, we analysed and examined the incurred costs, benefits and risks, in order to hedge the exposure with the optimal hedging strategy that provides**

the greatest security and the least cost. For this analysis, we primarily used and examined the so-called graphs showing „profit and loss" values and strike rates valid at maturity. During the analyses, we drew the following conclusions for each strategy:

Prompt and spot transactions

With prompt and spot transactions, our company would be able to hedge its exchange rate risk at significantly more favourable exchange rates compared to the target exchange rate, therefore the examined transactions can be said to be the most favourable on the cost side overall.

Despite the above, we rejected the possibility of hedging with both a prompt and a spot transaction, as they impose a payment obligation on the company for the value of the entire transaction upon conclusion of the transaction (prompt transaction) or 2 working days after the conclusion of the transaction (spot transaction). Based on the company's liquidity plan, the HUF hedging was not available at the value dates, therefore the company would not have been able to meet its payment obligations related to the transaction.

Future hedging (forward transaction)

Hedging with a forward exchange rate agreement is favourable for the company on both the cost side and the hedging side. Compared to the target exchange rate, it provides protection against unfavourable exchange rate movements at a level 7.70 forints lower, which means a cost advantage of 77 million forints, therefore we considered hedging with a forward transaction to be supportable in the current market environment.

In the case of the FWD transaction boosted with the knock out level of EUR/HUF 415.00, the forward exchange rate improves to EUR/HUF 397.00, while in the case of the knock out level of EUR/HUF 435.00, it improves to EUR/HUF 401.00, which also proves to be a good alternative for the hedging strategy during its formation.

Plain vanilla option

In the case of hedging with the plain vanilla option, taking into account the effect of the option premium, the strategy does not allow the target rate of exchange to be protected, since the effect of the premium raises the total price of the transaction above the target rate of exchange by HUF 3.30, which, calculated for the total exposure of EUR 10 million, represents an additional cost of HUF 33 million compared to the planned cost. Due to the above, we rejected the possibility of hedging

with a plain vanilla transaction under the current market conditions and in the context of the target rate of exchange.

Zero cost collar

In our case, the zero-cost collar strategy provides little room for manoeuvre, because when examining the exchange rate to be hedged, when the hedging strategy was created, the ATMF exchange rate was very close to the exchange rate to be protected. The exchange rate of the purchase obligation corresponding to EUR/HUF 410.00 of the long call was HUF 7.70 apart (this allows only 1.94% volatility), which limits the possible outcome of the transaction to a very narrow range.

Despite everything, we consider hedging with the transaction to be supportable, because the most unfavourable outcome is the same as the target rate of exchange, i.e. the company does not suffer a loss compared to the target rate of exchange, but this strategy imposes an obligation on the company at a level lower by 4.30 fillérs per euro compared to FWD, which means a HUF 43 million advantage in the case of the most favourable outcome.

In exchange for the 0.68% premium, the exchange rate of the put can be reduced to EUR/HUF 392.00 under the market conditions prevailing at the time of the strategy's creation.

Participating forward

The participating forward transaction combines the advantages of option transactions and the forward exchange rate agreement at the level of EUR/HUF 409.70 (and below the target price), therefore it provides a high degree of protection in the event of an increase in the EUR/HUF exchange rate and allows you to share in 50% of the total amount from favourable market movements in the event of a decrease in the EUR/HUF exchange rate. In our view, the strategy can be supported – albeit to a limited extent – with the fact that an advantage over the FWD strategy can only be seen at levels below EUR/HUF 395.00.

In summary, it can be said that out of the four examined transactions, three transactions (the forward transaction, the zero-cost collar strategy and the participating forward transaction) were identified as meeting the requirements set by the company, and that these transactions provide a high degree of security in the event of possible fluctuations in the interbank foreign exchange market in case of exchange rate changes, taking into account the costs.

Table 6
Comparative table of the examined transactions

Type of hedging	Rate	Amount of hedge	Target rate	Difference (HUF/EUR)
FWD	402.30	4 023 000 000	410.00	7.70
Boosted FWD (KO @ 415)	397	3 970 000 000	410.00	13.00
Boosted FWD (KO @ 415)	401	4 010 000 000	410.00	9.00
Plain vanilla option LC @ 410.00	413.30 *	4133000000	410.00	**–3.30**
Zero cost collar max	410	4 100 000 000	410.00	0.00
Zero cost collar min	398	3 980 000 000	410.00	12.00
Collar max	412.67 *	4 126 700 000	410.00	**–2.67**
Collar min	394.67 *	3 946 700 000	410.00	15.33
Part. FWD	409.7	4 097 000 000	410.00	0.30

Note: *with premium
Source: own editing

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FIDUCIARY ASSET MANAGEMENT

As a means of founders' transgenerational succession strategy

Tibor Zoltán Hajdu[1]

ABSTRACT

The 1990s generation of the fall of communism has reached retirement age by now, so the time has come for a generational transition. Studies on the succession of family enterprises mainly focus on internal factors such as professionalisation, involvement of external managers, successors' socialisation, or the issue of asset values. However, the institutional environment shaping succession options including inheritance law, formal intermediaries, succession-related tax rules also have a major impact on the long-term survival of family businesses and the transfer of wealth from one generation to the next. The objective of this paper is to shed light on the peculiar features of family enterprises and their internal factors defining succession alternatives in this country. It intends to describe the formal set of institutions and the relationship between those institutions, transgenerational wealth transfer, and succession strategies. In the case of mixed exit strategies, it analyses the options, advantages, and risks of the application of fiduciary asset management as one of the "wedges of asset management" between the principals of family enterprises and the managers.

JEL codes: D64, K36

Keywords: fiduciary asset management, family enterprise, succession alternatives, strategy of succession, asset transfer

1 INTRODUCTION

The set of family enterprises is an infinite multitude that consists of extremely diverse components. Its components change in time while it is also characterised by major geographical differences. The relationship between the family and the enterprise is different if there is an ownership community of the founder including siblings and cousins (*Gersick–Davis–McCollom–Hampton–Lansberg*, 1997). The

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actual family and its legal concept identified in different legal systems may also be different (*Zellweger*, 2017). Differentiating family enterprises from non-family enterprises using further factors (*Astrachan–Klein–Smyrnios*, 2002) in addition to the trio of family, ownership, and management (*Tagiuri*–Davis, 1996) is even more complex. There are differences in different geographical regions and countries because of diverse social systems, the size of enterprises and the different legal systems (inheritance laws). Whichever approach is used for analysis, their being transgenerational bridging families and generations is a key characteristic for the separation of family and non-family enterprises.

Transgenerational asset transfer, however, is not restricted to the handover of material assets - the family enterprise and the business portfolio. Transferring non-material assets, socioemotional wealth (SEW) also become emphatic in addition to asset transfer. Family enterprises accumulate certain immaterial assets in time (social capital, know-how, set of skills, emotional ties) and their transfer is at least as important and significant as the transfer of material assets (*Carr–Chrisman–Chua–Steier*, 2016; *Chirico–Gómez-Mejia–Hellerstedt–Withers– Nordqvist*, 2020).

The social-emotional set of values is different with different family enterprises. Another difference is subject to the part of the life cycle an enterprise is in. The emotional bonding and the succession strategy of a founder-principal to their enterprise is different from that of a second or third-generation family member-principal(s) where multiple ownership and a heterogeneous family ownership structure has already been formed. Succession strategies and the long-term survival of family enterprises are also defined by the external institutional environment they operate in. What formal intermediaries provided by law are available? Different jurisdictions have different succession systems that generate different patterns of transformation in family enterprises. Rules of inheritance have a direct impact on both the lifespan and the value of family enterprises (*Carney–Gedajlovic–Strike*, 2014).

Their position in their life cycle and the formally available institutions together define potential succession alternatives for family enterprises and provide the framework of succession strategies.

The aim of this paper is to describe succession options and potential inheritance strategies after a review of the internal factors and external institutional environment of transgenerational asset transfer. The peculiar features of SMEs and family enterprises in Hungary are analysed. I offer a detailed analysis of the scheme of fiduciary asset management as one of the mixed exit alternatives temporarily transferring principals' disposal authority, the options, and cases of its application subject to the situations of succession. The advantages and risks of fiduciary asset management will be analysed from the aspects of the principal, the beneficiary and the assets managed (the family enterprise).

2 THE ISSUES OF TRANSGENERATIONAL ASSET TRANSFER

Studies on succession mostly examine the rate of long-term survival of family enterprises and of the SME sector in a wider sense in connection with internal company factors. The issues studied in connection with the transgenerational transfer of assets and family enterprises include the transition from a family enterprise into a professional company (*Rutherford–Kuratko–Holt*, 2011; Gersick–*Lansberg–Desjardins–Dunn*, 1999; *Stewart–Hitt*, 2012), succession planning by the enterprises (*Murray*, 2003; *Eddleston–Kellermenns–Floyd–Crittenden–Crittenden*, 2013), the integration of external leader-managers into management and the socialisation of successors (*Klein–Bell*, 2007; *Chittoor–Das*, 2007; *Steier*, 2001) or the problem of the asset value of enterprises (*Bennedsen–Nielsen–Perez-Gonzalez–Wolfenzon*, 2007; *Zellweger–Kellermanns–Chrisman–Chua*, 2012).

The studies on the succession and professionalisation of family enterprises usually neglect the external factors of asset transfer (Carney–Gedajlovic–Strike, 2014). External factors are related to three dimensions, which can be deducted from the inheritance law of a given economy, since the form of transgenerational asset transfer is defined by (i) testamentary freedom, (ii) the presence, advancement, and judicial format of “intermediaries” or “substitutes”, and (iii) the system of property- and inheritance taxation.

Testamentary freedom is the degree of individuals’ freedom to dispose of their acquired assets, which relates to the future. Testamentary freedom is higher in legal systems where common law is decisive (typically in English speaking countries) than in countries of continental law (*Ellul–Pagano–Panunzi*, 2010). Limitations to testamentary freedom appear in legal provisions on inheritance. In addition to formal requirements, legal provisions define minimum material rules, such as forced share, beneficial ownership, etc. However, too many limitations of testamentary freedom may have a counter-productive effect because overregulation may have a negative impact on the economic development of family enterprises or may result in lower investment rates ((Carney–Gedajlovic–Strike, 2014).

“Intermediaries” or *“substitutes”* are *“fiduciaries”* external to the family (or the principal), whom the principals (founders) of family enterprises authorise to manage the affairs of the beneficiaries (heirs or persons made heirs) so that they should also supervise the managers leading the enterprise. The founders (principals) set up a dual agency relationship (Zellweger–*Kammerlander*, 2015; *Child–Rodrigues*, 2003), in which the “substitutes” (second agency level) monitor the managers (first agency level) in a vertical order of dual separation of ownership and control. After being set up, those legal “substitutes” develop a life of their own and acquire an autonomous company-organisational form. The number of “substitution forms” as means of the founders’ transgenerational succession strategy

is continuously growing because of economic development and the evolution of rules relating to asset management, property, and securities.

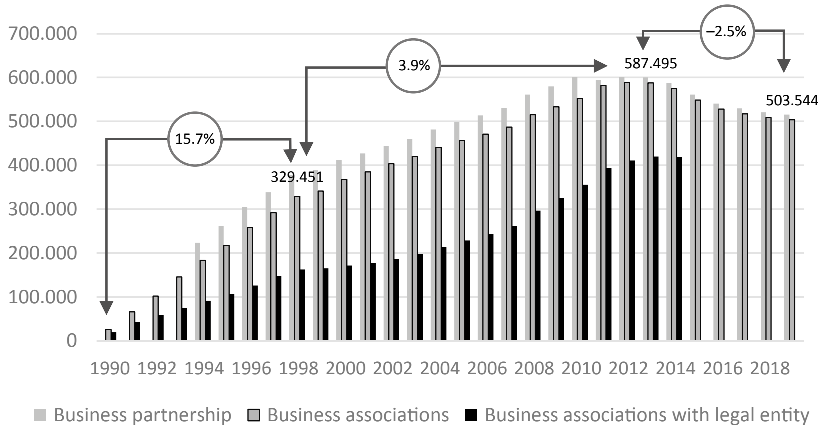
Property and inheritance taxes may be incentives or limitations that either hinder or facilitate the transfer or reassignment of capital (assets) from one generation to the next. The lack of property or inheritance taxes preserves the assets intended to be "reassigned" between generations. On the other hand, inheritance taxes highly fragment and reduce the value of assets available for the next (heir) generation, so the vitality and longevity of family enterprises will suffer. Any limitations regarding the inheritance or share of assets (property taxes) withdraw the relevant assets from the market, as the movements of the assets are defined by legal provisions rather than by market forces.

Transgenerational asset transfer in the form of long-term asset management will preserve capital cohesion (unity), but, paradoxically, the balance of asset management will shift towards safeguarding rather than asset accumulation or value growth (Carney–Gedajlovic–Strike, 2014).

3 THE PECULIAR DEVELOPMENT FEATURES OF SMES AND FAMILY ENTERPRISES IN HUNGARY

Following the fall of communism, thousands of private enterprises mushroomed from "top to bottom" as state ownership was dissolved in spontaneous privatisation, or "bottom to up" in the form enterprises built on individuals' ideas and business ambitions. The growth lasted until the 2010s, then it turned into a permanent decline. No mass generation shift had occurred by that time, the founders were still the leaders of their enterprises while the population in their thirties or forties at that time (the generation promoting the fall of communism in the 1990s) has reached retirement age by now.

Figure 1
Evolution of the number of partnerships, companies and companies with legal entity and the average growth rate of companies in the period 1990–2019



Source: http://KSH Number of partnerships[2] (own design)

One can see from the scarce statistics available that there is a high number of enterprises in which an "exit pressure" is mounting because of their principals' ages. Based on their principals' ages, "over half of the enterprises, about twelve thousand, with sales revenues of over HUF 100 million will soon face the challenge of generation shift in some form. Calculations have shown there are about 850 privately owned medium-size companies with sales of over EUR 1 million (HUF 350-360 million) in which the average age of the principals is sixty-two"[3]. The number of enterprises owned by 60+ individuals is 53 thousand[4].

The exit of the founding generation, setting up succession strategies and the actual implementation of transgenerational asset transfer is made difficult by (i) the lack of experience and preparedness of the principals, (ii) the lack of preparedness

2 Downloaded on 22.11.2020.

3 Ministry of Innovation and Technology (2019). The strategy of strengthening Hungarian micro, small and medium-size enterprises (2019-2030). Ministry of Innovation and Technology, Budapest.

4 National Bank of Hungary (2019): Financial stability report, May 2019. Budapest: National Bank of Hungary.

of the companies, (iii) the fast changes of the economic environment, and (iv) the lack of an established institutional system.

(i) Hungarian SMEs and family enterprises are an extremely heterogenous group. One can find among them false self-employment hiding employment but securing a family's existence, some that were acquired and structurally inherited via spontaneous privatisation, but also some that are suppliers to multi-national corporations or ones making use of opportunities of market growth that have established modern company operations. The risk, however, is not presented in the diversity of enterprises but in the lack of the founder-principals' exit strategy and their complete or partial *unpreparedness* for the generation shift. No experience of several years is available around them, nor have they access to models or transformation patterns to be copied from other enterprises.

(ii) The growth and development of companies goes hand in hand with the expansion of employee numbers, while internal operational processes become more complex. This necessitates that the enterprise must become professional relevant to its degree of development (Stewart–Hitt, 2012). There are different dimensions of corporate professionalism or "self-propelled" operating mechanism independent of the principal including an effective company management system, formal financial and controlling systems (*Giovannoni–Maraghini–Riccaboni*, 2011) and formal HR systems. The organisational structure and operation of Hungarian SMEs and family enterprises typically *has not been prepared* for an existence independent of the founder. It is the principal-manager alone who possesses the leadership and operating "know-how" and skills and no successor manager has been selected either internally from the company or externally. Decision processes are concentrated in one hand, professionalisation has not started yet or it is rudimentary.

(iii) The *economic environment* is in a process of major changes. The fourth industrial revolution, digitalisation breaks down the traditional value chains built on each other and generates a circular "platform" economy (*Kenney–Zysman*, 2016). Big data, fast access to the market and information and technological developments simplify and shorten market penetration channels and times. Pressure by financiers and investors to consider environmental, social and governance (ESG) factors has a major impact on company cash-flows and results in an operational-financing environment significantly changed (*Friede–Busch–Bassen*, 2015).

(iv) Further obstacles include *different interpretations, the lack of uniform definitions and a self-propelled set of institutions* supporting succession. To identify family enterprises in this country, researchers use the most accepted international definitions for a start (Chua–Chrisman–Sharma, 1999; Astra-

chan–Klein–Smyrnios, 2002; Chrisman–Chua–*Pearson–Barnett*, 2012) and consider the trio of family, company, and ownership but from a different aspect and to a different degree (*Wieszt–Drótos*, 2018; *Kása–Radácsi–Csákné*, 2017). It is difficult to provide a uniform definition because we are still on the threshold of a mass generation shift (successors of the generation of the fall of communism); the second generation has just started to 'settle in' and take part in the management of private companies. There is little domestic experience about the part played by institutions supporting the succession of family enterprises (fiduciary asset management, asset management funds, private capital and investment funds, holdings) in a generational change. Fiduciary asset management[5]and asset management funds[6] are relatively new legal institutions, the number of available cases is low.

4 SUCCESSION STRATEGIES AND ALTERNATIVES

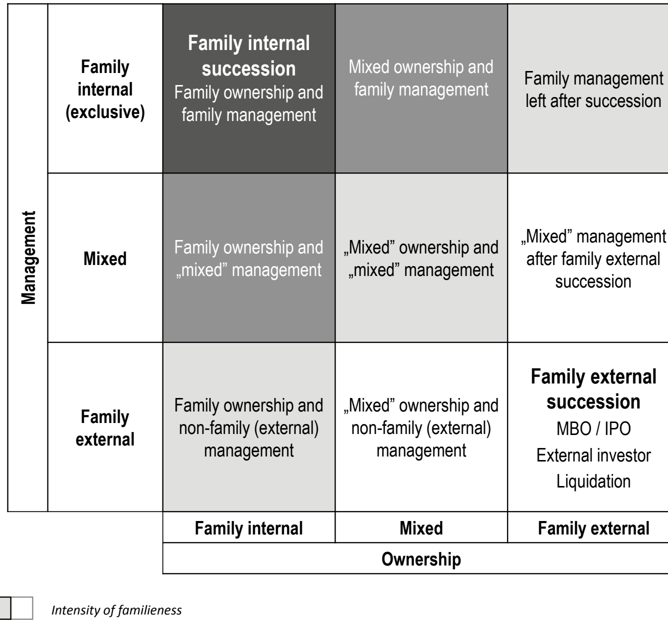
Apart from family ownership and family control, family enterprises also must have a *vision,* intentions, behaviour, and decision relating to the future of the enterprise so that it could survive for generations (Chua–Chrisman–Sharma, 1999). The ability and willingness of the "transferee" (the next) generation to adapt, the presence and quality of the handover strategy, the "exit strategy" of the "transferor" (previous) generation are critical success factors in succession[7]. The *exit strategy* covers the principal's (the first-generation founders typically in Hungary) ideas and will regarding company ownership and management in future. Ownership and management can be transferred to a family member (internal to the family) or to a person external to the group of relatives, but it can also occur jointly (mixed transfer). The theoretically possible combinations of the above two factors (ownership and management) will define the alternatives and options of "succession exit" available to the principal.

5 Law V of 2013 promulgating the Civil Code, Book Six (contract law, other agreement related regulations), Part Three (Agreements) Title XVI (Agency agreements), Chapter XLIII (Trust management contracts)

6 Law XIII of 2019 about asset management foundations

7 Natural succession is due to unplanned, external circumstances, the passage of time (in the event of death). "Exit succession" is when the owner of the business voluntarily succeeds the business of his own free will and intention.

Figure 2
Succession alternatives subject to the nature of ownership and management



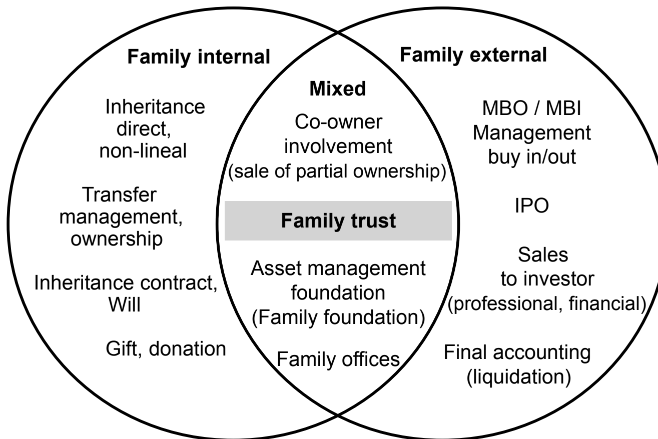
Source: Zellweger (2017) and own design

Realistic and plausible *exit alternatives* are defined jointly by the internal operational features and the external environmental factors of specific family enterprises.

Internal features include the capabilities of the descendants ((*Lee–Lim–Lim*, 2003), the heterogeneity of family members and family relationships (Chandler, 2015; Zellweger–Kammerlander, 2015), the size of the enterprise and the complexity of its assets (Chandler, 2015; *Westhead–Wright*, 1998), factors related to the position of the enterprise in its life-cycle (*Le Bretton-Miller–Miller*, 2013; Gersick–Lansberg–Desjardins–Dunn, 1999), or to its development and professionalism (Stewart–Hitt, 2012; *Dekker–Lybaert–Steijvers–Depaire–Mercken*, 2013; Dekker–Lybaert–Steijvers–Depaire, 2015), which all define the degree of independence of the enterprise of its founder, the "measure" (distance) of the split. *External factors* include the institutional environment defining exit alternatives for succession, (i) *inheritance rules,* (ii) the available *set of institutions* and (iii) succession related *taxation issues.* They will define the nature of asset transfer, transfer within or

without the family or mixed (temporary), i.e., how and in what form the family enterprise will be handed over (the family assets distributed).

Figure 3
Succession alternatives subject to formal sets of institutions



Source: Zellweger (2017) and own design

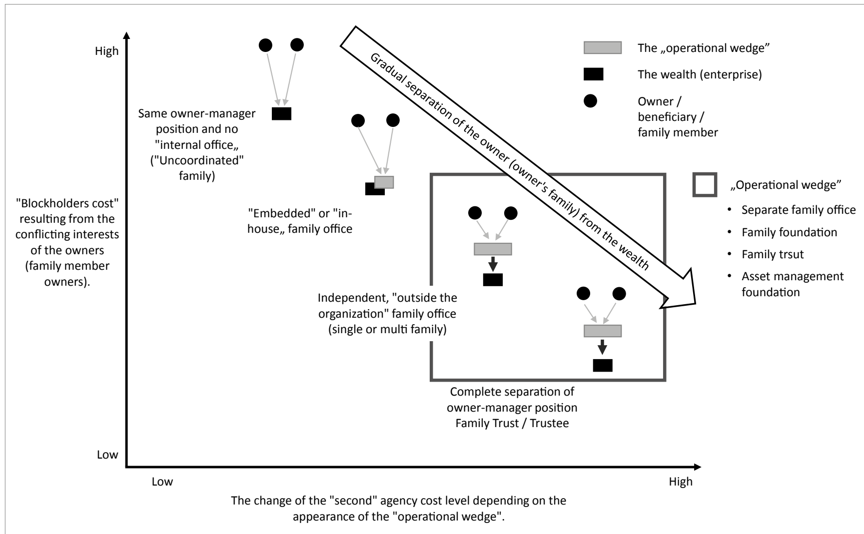
a) *Succession within the family* means the *direct transfer* of ownership and management positions to family members, to the next generation. In the case of intestate succession, the family enterprise as property is transferred to the heirs independent of the principal's will, according to the share-distribution provided in law (equally shared). The Civil Code (Law V of 2013) includes a list of persons entitled to inherit. Inheritance is based on consanguinity (except for adopted children) in a strict order stipulated by law. In case of a disposition of property upon death, the testator is free to dispose of their assets except for one significant restriction (reserved share). It can take the form of a will, a contract of inheritance or a gift upon death (donation mortis causa).
b) In the event of *succession external to the family,* the ownership and management functions *are removed from the family circle,* i.e., neither descendants nor relatives take over them, they are transferred to persons external to the family, so the enterprise loses its family nature. Alternative forms of implementation include the sale of the company (immediate, optional, or forward sale), management buy-in or buy-out, public offer or private sale to professional or financial investors. A special case is the termination of a family enterprise without legal successor, liquidation or winding-up.

c) *“Mixed type”* exit alternatives are schemes when the management of the *transfer of the assets is temporary.* In the first phase of its life cycle a family enterprise is a monolithic culture, it is characterised by converging interests and the principal-manager’s preferences only. When the enterprise is transferred to the descendant generations, the group of principals may become multiple (inheritance, involvement, sale). Although shared interests to increase asset values remain, different preferences will appear regarding risk assumption, dividend policy, the time horizon of growth, investment strategies or social preferences, so the monolith culture will be broken up. Conflicts may appear within the group of principals. The number of a principals’ group and their contradictory interests may generate major costs as decision making becomes complex, operation loses effectivity, non-rational preferences or different risk assumption ideas appear (“block holders” costs) (Zellweger–Kammerlander, 2015).

As ownership and management positions are distanced, institutional forms are bound to appear, which are wedged between the principals and the managers controlling the enterprise, to ensure effective operation of the assets. Such institutions function as *“asset management wedges” because* they will settle conflicts among the principals, find a common platform for their interests and are able to ensure growth, operation, and income production. Such institutional forms may include a separate family office, a family fund, fiduciary asset management or an asset management fund.

Employing an external manager by the enterprise generates agency costs (bonus, other benefits) to be paid so that the manager’s interests should not be different from those of the principal (*Jensen–Meckling*, 1976). If the assets and the family are separated, the trustee, the institution of a fiduciary asset management wedge, will be the intermediary between the asset holders (the family) and its operating manager (operator of the assets). According to Zellweger, there will appear a “dual agent” (Zellweger, 2017), as the asset manager is commissioned to manage the assets and will be in an agent’s position vis a vis the principal (the family). On the other hand, the agent will start to behave as a principal towards the operating managers (agents) of the enterprise.

Figure 4
Forms and position of an "asset manager wedge" subject to agency/block holders' costs



Source: Zellweger–Kammerlander (2015) and own design

The assets and the family may be separated as the succession strategy of a family enterprise is established. The institutional form applied, the type of asset management wedge, depends on the degree, at which the principal (settlor), the principal of the family enterprise intends to separate the assets and the person of the successor. On the other hand, their options are limited by the availability of *substitute institutional forms, the types of asset management wedge.* Alternatives are defined by economic-social development, civil law codes, the rules of inheritance and securities or customary law. In Hungary, fiduciary asset management (Law V of 2013. Book Six, Part Two, Title XVI, Chapter XLIII and asset management funds (Law XIII of 2019 on asset management foundations) have been regulated, but other forms of substitution such as a family office can also be applied.

In addition to economic-financial considerations, the selection of a succession strategy is influenced by the wish to maintain the social-emotional wealth accumulated in the enterprise (Chirico–Gómez-Mejia–Hellerstedt–Withers–Nordqvist, 2020), the successor's capability, the principal's confidence or worries of how much the successor will be able to accept the real material nature of family assets such as property, money, assets as well as its immaterial nature including family values, faith, traditions, or social sensibility (Carr–Chrisman–Chua–Steier, 2016).

5 FIDUCIARY ASSET MANAGEMENT

There are several legal options for separating ownership and asset management: (i) establishment of a company with legal entity, which is separated from the members and (ii) binding contractual legal relationships where one legal entity receives the legal position needed to make principals' decisions so that the profit so produced will increase the assets of another legal entity (*Menyhárd, Békés B.* et al., 2020, Chapter I). A company, a fund or an asset management fund are independent legal entities, fiduciary asset management is a contractual relationship. The form best meeting the objective of asset management is subject to the principal's intentions and goals, the economic-social environment, the legal and taxation environment, and transactional costs.

Fiduciary asset management is a fairly new economic-legal form available for economic players, it took effect under the Civil Code on 15 March 2014 (Act V of 2013 promulgating the Civil Code, Book Six (Contract law, other agreement related regulations), Part Three (Agreements) Title XVI (Agency agreements), Chapter XLIII (Fiduciary asset management contracts).[8]

"In the course of fiduciary asset management, a legal entity transfers disposal rights over the assets it owns to another legal entity, which must utilise the assets transferred to the benefit of the principal or a third party by exercising the decision rights so received" (Menyhárd, Békés B. et al., 2020, Chapter I). Fiduciary asset management is a three-player legal relationship, the players are the principal, the asset manager, and the beneficiary. It means an asset manager other than the principal receives ownership (disposal) rights on condition it must make its decisions related to the management and use of the assets so that the return made on the assets will increase the beneficiary's assets. It is a legal transaction where "one legal entity (the principal) transfers ownership of certain things, rights and claims representing its assets to another legal entity (the asset manager) that must utilise the assets entrusted to it to the benefit of a third party (the beneficiary) by exercising the decision-making rights so received" (*Vékás* et al., 2018, Chapter XLIII).

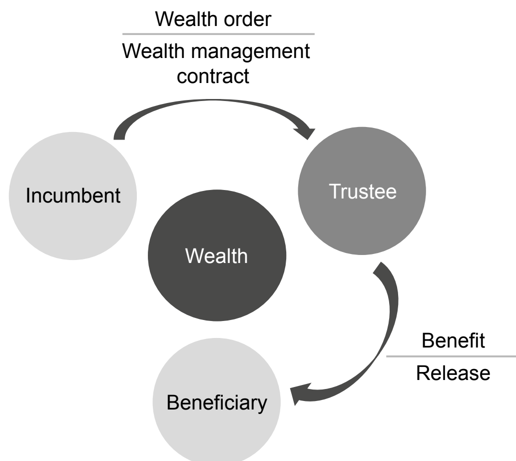
Fiduciary asset management can be established by means of any legal transaction including a contract, a will or a unilateral legal declaration and consists of two consecutive moves of asset transfer in opposite directions, a transfer of assets and a release of assets. Transfer of assets takes place when the relevant contract

8 Its application is helped by additional regulations, Law XV of 2014 about trustees and the rules of their activities (Bvktv) and Government decree 87/2014 (III.20.) on certain rules of financial guarantees of fiduciary asset management companies.

is concluded, and when the contract expires, the asset manager will release the assets to the beneficiary identified in the contract. Although an asset manager obtains unlimited ownership of the assets managed under rights in rem, but it is limited by contract law through the conditions of asset management and the beneficiaries' interests specified in the contract (*Sándor* et al., 2018). The principal will "lose" the assets by transferring them; its ownership (control of the assets) ceases as well as all its rights from ownership, i.e. the right of disposal, possession, use and taking the profit.

As regards its economic content, fiduciary asset management is *asset circulation:* the assets are transferred, managed, and released. Like swap transactions, it can be described as a combination of *two transactions of opposite directions,* one is the asset transfer and other is the release of assets to a designated person when the contract expires (reversion). In the period between the transfer and the release an asset manager has *management commitments* over the assets transferred because of the transfer of disposal rights. Since assets change continuously and dynamically, the management commitments require asset value to be preserved and increased and to provide the beneficiaries with the contractual benefits.

Figure 5
Structure of fiduciary asset management



Source: Own design

The principal component of fiduciary asset management are *the assets managed* transferred to the asset manager by the principal. A settlor will not transfer all

their property in the legal sense but certain assets or their totality as assigned[9] and an asset manager will manage them as a distinct entity separated from its own property. An asset manager will only manage "active" assets (assets, instruments), things, goods and claims on its own behalf but to the benefit of the beneficiary in return for a fee paid by the principal (settlor). A fiduciary asset management contract is an inverse onerous legal transaction because the party obtaining property rights, the asset manager, will be entitled for remuneration rather than the transferring principal (settlor).

Fiduciary asset management regards property as a distinct whole, because "any asset, sum insured, damages or other valuables that replace a managed asset from the trust property, and any benefits generated by these shall be part of the trust property, even if they do not appear in the records" (Civil Code, Section 6:312 paragraph (3).

5.1 Fiduciary asset management as a means of managing succession situations and succession strategy

As the ownership structures of family enterprise become heterogeneous as a result of transgenerational asset transfer (succession and multiple inheritance) (Kellermanns–Eddleston–Barnett–Pearson, 2008), or the lack of the successors' ability, capability, readiness or will, a risk arises for the going concern or efficient operation of the enterprises (Chirico–Gómez-Mejia–Hellerstedt–Withers–Nordqvist, 2020). The more the management and family and principals overlap, i.e., the stronger an enterprise is embedded into a family, the stronger is the impact of problems and challenges rooted in natural persons' life situations and incurred in connection with company operations. Each case, i.e., the heterogeneity of the principals' group, the successor's suitability and capability or the natural person's life situations entails a risk regarding uninterrupted company operations, and the implementation of its growth and sustainability business. In any situation fiduciary asset management can be a long-term or temporary effective and suitable instrument of company operation so that a conscious and intentional suc-

9 The Civil Code identifies the concept of an asset in the interpretative provisions (Civil Code, Section 8:1 (1), paragraph 5: "asset means a thing, a right, or a claim"), but it fails to give a definition of property as "the totality of property rights and obligations connected to a person of legal entity" (Tamás Lábady [2017]: A magánjog általános tana [General principes of private law]. Budapest: Szent István Társulat, 213.) As regards fiduciary asset management, the Civil Code explicitly defines the content of "assets managed", as they are "the things transferred to his principalship as well as the rights and obligations transferred to him by the principal (hereinafter: "trust property") (Civil Code, Section 6:310 paragraph (1)

cession strategy with proper foresight be implemented. Different situations may arise, such:

(i) *Intention to continue operations.* Fiduciary asset management is a suitable means to ensure uninterrupted company operations because the owner as principal transfers the whole enterprise as property including all ownership and disposal rights to a professional asset manager and authorises them to manage and control it. The asset manager will proactively manage, organise, and control the enterprise in accordance with the provisions of the relevant contract including contractual limitations. Such a situation may arise if an owner, despite their intention to exit, cannot sell the enterprise to a third part or there is no suitable descendant to continue it.

(ii) *Lack of capabilities.* A situation may arise when there are descendants or family members for continuation, but their capabilities do not make them suitable for takeover. Fiduciary asset management offers the principal an opportunity to establish an operating and legal scheme by transferring the enterprise to a professional asset manager. The descendants will share capital income or receive certain predefined allowances.

(iii) *Lack of preparation.* In this case there are descendants or family members, but the owner-principal is of the opinion they do not possess the proper experience or qualifications yet. Applying fiduciary asset management, an enterprise can be transferred temporarily (for maximum 50 years) to an asset manager that will operate it until the designated successor(s) have prepared for assuming direct control. A principal may explicitly identify the conditions to be met by the successor(s) before they can take over the company.

(iv) *Incapacity.* In this situation there are no descendants of capacity yet or at all because they are underage, their discretionary power is limited, or they are long-term incapacitated. By using fiduciary asset management, a settlor can ensure the enterprise will be managed with proper care and readiness until a minor becomes of capacity or ready. If a descendant is long-term incapacitated, fiduciary asset management will guarantee to the principal the assets transferred (the family enterprise) will be managed according to their guidelines, and the designated beneficiary will be provided for until the end of their life through the allowances identified.

(v) *Preparation for future.* Fiduciary asset management is a suitable means to continue an enterprise if the principal while still alive transfers it to an asset manager provided, they identify the guidelines and rules of asset management relating to the enterprise or group of companies transferred at the time they are transferred. In that way, a principal can "control the future" while still at an active age and can make sure how the enterprise will be contin-

ued. The settlor can identify the principles of preserving and increasing asset value (asset management principles) as well their ideas including investment policy, dividend payments, expectations of return and profit to be applied by the asset manager to operate the company. The break-up may occur step-by-step too. A settlor may hold a temporary position in asset management (they may be a temporary asset manager or may take a position in the asset management company).

(vi) *Avoid fragmentation.* By applying fiduciary asset management, an owner-principal may prevent that the company should be cut into pieces during inheritance and conflicting interests arise among the principals. If a principal has more than one descendant (multiple inheritance), there is a danger that after the principal's death the heirs will have different preferences regarding their share. Conflicts may arise regarding the operation, growth of the company, about dividend payments, investments or selling shares, which may jeopardise the chances of maintaining the company, preserving its value or provide growth. By fiduciary asset management a settlor can make the property "independent" by transferring it to an asset manager so that the nature of allowances due to the beneficiaries and their timing are specified in the relevant contract. Heirs will not receive shares but (as beneficiaries) an "annuity-type return" on the assets.

Fiduciary asset management is a suitable means to manage succession, as it can ensure continuity, the uninterrupted operation of the company. It can provide capabilities or skills lacking temporarily or long-term that are not there, or the successors have not obtained them yet. It can bring about changes such as professionalisation, changes in organisational operational or control strategies that will promote the long-term survival of the enterprise, retain an increase its values. Fiduciary asset management is also suitable to implement a principal's succession strategy because it can provide smooth connections between the company and the family in future in the long run.

5.2 Pros and cons of application

By transferring the property, the family enterprise, into fiduciary asset management, i.e., transferring ownership position "for a definite time", a principal can prevent that heterogeneous ownership positions arise through inheritance. In addition, a principal can acquire capabilities for themselves, and the assets transferred for management (the enterprise) they did not have earlier, or they did not have the necessary resources for, or they were deficient.

A principal can exercise *future control* over the assets transferred for management. A founder-principal can define in his lifetime the future fate of the enterprise by transferring it into fiduciary asset management. They can identify the principles and values in the asset management contract that must be used by the asset manager in future. They can identify the principles of asset management including the principle of safeguarding the assets, the principle of profit expectations, the principle of risk avoidance, etc., as well as guidelines relating to investments, such as safeguarding, long-term investment approach, profit maximisation, diversified portfolio management, etc. They can also ensure by fiduciary asset management that the enterprise is operated by a suitable person (asset manager) instead of an unsuitable or unprepared heir.

Asset management can ensure *going concern operation,* because it guarantees continuity of management even if there is a change or unexpected turn in the life of the principal. By using fiduciary asset management, a founder-principal can ensure the continued operation of the enterprise in the event of their death, illness, or incapacity. As ownership rights and operations are transferred, the decisions linked to ownership such as powers at general meetings, the increase or decrease of equity capital, the sale of the company, dividend payment, merger, etc. can be made in future independent of the principal's person ensuring in that way the functionality of the company.

It provides *secrecy,* as a non-public asset management contract allows the principal to become "invisible". A settlor can transfer the property into the asset manager's ownership for a definite time through fiduciary asset management, who will manage it as their own and will appear as principal to "the outside world". The fiduciary asset manager will be entered in the share register and will appear to third parties as a direct contracting party.

The scheme also provides a principal with *taxation advantages* and profit. It can optimise taxes because by transferring the enterprise into fiduciary asset management the revenues from ownership including dividend income or revenues from the decrease of share capital and other capital transactions will be due to the asset manager, so a settlor will not have to pay taxes on such movements. A settlor can transfer the assets selected and their "yields and incomes" to the asset manager through fiduciary asset management, so the principal's tax payments will be reduced.

It also allows *keeping the property,* because the heirs' direct rights over the property cease. By applying fiduciary asset management, the principal can ensure that the company will not be distributed, situations of multiple inheritance or conflicting inheritance cannot hinder company operations. The principal's decision mechanisms and decisions about company operations remain coherent, conflicting views and positions do not appear at general meetings, because it is guaran-

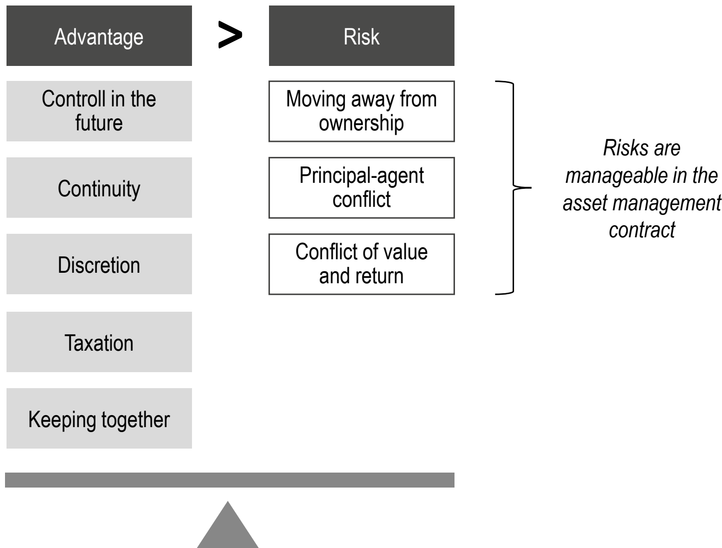
teed by the person of the asset manager and their exclusive responsibility for asset management. The heirs will only receive beneficiary allowances.

Transferring into fiduciary asset management opens the way for the professionalisation of the company. A principal can acquire skills from the asset manager or order professional, industrial and technical expertise ("knowledge transfer") the enterprise lacked earlier or that he could not accumulate by himself. So, a settler can assign professional knowledge and competences to the enterprise transferred that are necessary for its management and continuous operation, the development of its business relations and market growth.

Transfer into asset management allows *professional business optimisation.* Fiduciary asset management allows the application of better organised management and operations of the enterprise as management, operating and decision processes are institutionalised. All that will improve company efficiency and lead to optimised structures of operating expenses. A principal "disconnects" from the enterprise as it is transferred to fiduciary asset management. The asset manager can reorganise the company, rationalise different corporate functions. They can reorganise financial and IT processes introducing controlled ones. Structured decision-making mechanisms will appear. Management and decision-making levels, procedures and protocols will be established. An internal company structure will reduce operating risk and optimise costs. Building an effective management information system (controlling, business intelligence) will improve the speed and effectiveness of decisions.

When an enterprise is transferred into asset management, the right of operating it (disposal right) is transferred from the principal to the asset manager. In that way the control over operations will be out of the principal's scope. This can be disadvantageous, but the related risks can be limited by the fiduciary asset management contract and supplementary rules.

Figure 6
Advantages and risks of fiduciary asset management



Source: Own design

Disconnect from property. A principal will cease to be the owner of the assets transferred; they will simply have a contractual relationship with the asset manager. A principal can offset their "waiver" of ownership by defining the principles and guidelines relating to the assets and the enterprise in the asset management contract. In a fiduciary asset management contract a principal may specify asset management principles they deem important, such as the principle of the retention of property, the principle of profit expectation, the principle of risk avoidance, the principle of liquidity as well as investment guidelines related to the assets such as adherence to a long-term investment approach, the proper level and measure of risk management, the application of business planning and the principle of ensuring proper professionalism and competence. In that way an asset manager will be committed to observe the provisions of the asset management contract and its principles.

Conflicts between the manager and the principal. Transferring an enterprise to an asset manager by its principal is not only the "loss" of ownership rights but also giving up operating control and management rights. A conflict of management and principal can also arise within the asset management group if the asset manager employs managers other than itself. A principal may prepare for that in the asset management contract and further agreements based on it, and can define

principles and directions, principles of asset management such as the principle of the retention of property, the principle of profit expectation, the principle of risk avoidance, the principle of liquidity as well as investment guidelines such as purpose limitation, a long-term investment approach, a properly diversified portfolio or profit maximisation that are binding so they will settle or mitigate manager-principal conflicts and their effects.

Conflict between asset value and return. During fiduciary asset management, a conflict may arise between the retention of asset value (safeguarding property) and the increase of its value, profit maximisation on the assets and the allowances due to the beneficiaries from the property. Too large allowance may withdraw funds from the company that are necessary for operation and growth, which reduces the income capacity of the enterprise and asset value. A proper balance can be maintained through suitable regulations in the asset management contract. In an asset management contract, a principal can clearly define their objectives related to the assets transferred (the enterprise), such as the retention of the property managed as a whole, adaptation of the enterprise to market and economic processes, the profitability of the enterprise, the retention of its profit generating capacity in proportion to capital, etc., and the principles of beneficiary allowances (when and under what conditions the beneficiaries receive their allowances).

6 SUMMARY

Succession is a critical issue for family enterprises (and SMEs). Not only because it is an event strongly affecting the future that occurs at a given point in time in an enterprise's growth and life cycle linked to a change in ownership but also because its success is subject to multiple corporate internal and external factors and assumes the joint presence of several types of competences linked to a natural person. No two succession situations are identical, but succession affects all company stakeholders including employees, customers, creditors, and business partners.

The economic-social situation, the necessity of exit is given; a shift of ownership and the separation or transfer of principal and manager functions must be implemented in the period of the generation change. An alternative of implementation is when the principal does not want to have the enterprise out of their sphere of interest, so they look for a form that will ensure retaining the enterprise within the family circle for a long time. In that event an intermediary (a "substitute" or "asset management wedge") may enter that will temporarily manage the property, the enterprise in the interest of the principal or persons identified by the principal. That type of asset management is temporary both in time and "space".

It is temporary in time, when the new generation is not yet prepared for taking over (it has not obtained the necessary knowledge) or if the new generation is not able to take over yet or not at all as it is not suitable, it lacks the necessary capabilities for takeover. It is also temporary in "space" as the principals of the assets having disposal rights change during the legal relationship while the property also changes. An asset manager must return the assets to a designated person at the designated date. However, the appearance of a third party, the intermediary, raises the problem of agency theory since that person will also consider their own interests when making decisions (principal-agent problem).

The legal system of a country will define the formal legal institutions available for filling the position of intermediary ("substitutes" or "asset management wedge"). The relevant rules have an impact on the long-term survival and viability of family enterprises, they define the "principal's" degree of freedom of disposing over their assets. If a legal environment is overly restrictive about disposal rights, the property becomes "dead money" (Carney–Gedajlovic–Strike, 2014), because it is fragmented in the process of successions or because disposal rights get lost.

Basically three factors identify the actual organisational-formal schemes or legal forms principals (founders) can apply for the asset management wedge as they design their succession strategies: 1. The measure of testamentary freedom, i.e., how free a person is to dispose of their property after death, 2. the presence of intermediary institutions, i.e., if there actually is a legal form that ensures free disposal of the assets and does not limit the flow of assets between the generations, and 3. property and inheritance taxes, i.e., the taxation system of a given country when a person dies.

To sum up, there exists an economic basis or business situation. It is objective since an enterprise must be continued and maintained, (or at least that is a rational goal) for the next generations. The legal superstructure will define the ways and means of succession, how a transgenerational asset transfer can be conducted.

Both the economic base and the legal superstructure have their characteristic features. They are the input variables for the economic base. Such input variables include the degree of development of an enterprise, how much the principal's and management's roles have been separated, the professionalisation of management and the organisation, the degree and acceptance of digitisation, the corporate-organisational culture, etc. The output variables are the characteristic features of the legal superstructure, i.e., the timescale of transfer, the scopes of authority, the degree of freedom and the nature of powers to be applied for a transfer. Fiduciary asset management is one of the forms of the asset management wedge. The characteristics of a family business and asset management constitute its economic content. Its legal superstructure is a fiduciary asset management contract that identifies the framework of its operation and the parties' relationship.

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87/2014 (III.20.) Government decree on certain rules of financial guarantees of fiduciary asset management companies

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MARKET SURVEILLANCE BY THE NATIONAL BANK OF HUNGARY AS ADMINISTRATIVE PROCEDURE

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ABSTRACT

In this paper I intend to study market surveillance procedures as one of the administrative procedures by the National Bank of Hungary (hereinafter: MNB or Supervision) from the aspect of procedural law. During my previous studies, I found no academic papers or only came across short articles on market surveillance, while legal practice over the past decade has required scientific support of the topic. In market surveillance procedures customers often lack proper knowledge about the nature of the proceedings; that is why I made efforts to present a paper that may assist them. In the following paper, the legal provisions relating to market surveillance will be reviewed including the customers, subject, the process, specific acts of procedural law, the data that can be learnt during the process, their management, the legal consequences to be drawn from the procedure, and finally the concept of market surveillance will be established.

JEL codes: E58, K10

Keywords: National Bank of Hungary (MNB), central bank, market surveillance, administrative procedures

1 INTRODUCTION

One can say in general that the MNB applies a preventive approach in administrative procedures, accordingly, market surveillance procedures do not focus on subsequent sanctions of legal violations, instead, they intend to prevent and manage potential future market surveillance risks.[2] Market surveillance is a specific

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2 Dr. Babai-Belánszky, Tamás – Dr. Barnóczki, Péter – Dr. Kardos, Gyula (2017): Piacfelügyeleti és fogyasztóvédelmi eljárások [Market surveillance and consumer protection procedures], in: Lehmann, Kristóf – Palotai, Dániel – Virág, Barnabás (eds.) (2017): *A magyar út – Célzott jegybanki politika* [The Hungarian way – Targeted Central Bank politics]. Budapest: Magyar Nemzeti Bank, 905. (hereinafter: Babai-Belánszky–Barnóczki–Kardos, 2017).

administrative procedure where the MNB acts as the competent authority if players of the financial market behave in a certain way.

Law CXXXIX of 2013 on the National Bank of Hungary (hereinafter: Central Bank Act) identifies the legal provisions relating to market surveillance procedures. Market surveillance is a[3] a specific administrative procedure belonging to the micro prudential surveillance activities of the MNB, and as such - progressing from specific to general rules - it is subject to Title 30, Chapter VII of the Central Bank Act on market surveillance procedures, Chapter VI of the Central Bank Act on the common rules of official procedures, and certain provisions of Law CL of 2016 on the general administrative procedure (hereinafter: Ákr).

It should be noted that this study focuses on the procedural aspects of market surveillance procedures, while a review of substantive law is not included because of its bulk and complexity. Considering that I have never met the concept of market surveillance procedure during my research, my objective was to establish a general concept for that specific supervisory procedure by the end of this study for two reasons. On the one hand, I wanted to achieve that the general public not engaged in market surveillance could interpret the nature and essence of the procedure, on the other hand, to provide jurists and economists with a clear, unambiguous definition of market surveillance. To understand the concept, I needed to study the legal provisions relating to market surveillance in detail.

2 THE MARKET SURVEILLANCE

2.1 Legal provisions related to market surveillance

As mentioned in the Introduction, market surveillance is subject to Chapter VI of the Central Bank Act on the common rules of official procedures and Title 30, Chapter VII of the Central Bank Act on market surveillance procedures - progressing from general to specific rules - as governing regulations. The latter includes the specific provisions related to market surveillance procedures. Considering that the objective of this paper is to analyse the market surveillance pro-

3 Dr. Kandrács, Csaba – Fenyvesi, Réka – Seregdi, László – Varga, Bence – Szegfű, László Péter (2018): Bankszabályozás és bankfelügyelés [Bank regulation and bank surveillance], in: Fábián, Gergely – Virág, Barnabás (eds.) (2018): *Bankok a történelemben: innovációk és válságok* [Banks in history: innovations and crises], 749., a series by the National Bank of Hungary. Budapest: Magyar Nemzeti Bank (hereinafter: Kandrács–Fenyvesi–Seregdi–Varga–Szegfű, 2018).

cedure, Ákr as underlying legislation is only presented as much as it is required for the description of a special MNB administrative procedure.

Section 8 (1) point f) of Ákr provides "the scope of this Act does not extend...to the administrative procedures of the National Bank of Hungary subject to Law CXXXIX of 2013 on the National Bank of Hungary, Section 4 paragraphs (2) and (5)-(9) and Law XV of 2014 on trust managers and the rules of their activities".[4] Accordingly, the MNB's official procedures are deemed to be outside the scope, which means those types of procedures - as a rule, in general and primarily - are not subject to the provisions of Ákr.[5] This, however, does not mean the Ákr is completely neglected in such specific official procedures. In such cases special procedural provisions identify the cases when a general provision of Ákr shall be applied as underlying legislation to a special rule.[6]

Pursuant to this dogmatic rule of Ákr, Section 46 (1) of the Central Bank Act provides the Supervision shall apply "in the course of the MNB's official procedure and inspection as defined by this law" and in certain issues not regulated in sectoral law the relevant provisions of Ákr, this Section (2). The following Table includes the cases when the relevant rules of Ákr shall be applied.

4 Hajas Barnabás (2020): Alapelvek és a törvény hatálya, I. fejezet [Basic principles and scope of law, Chapter I], in Petrik Ferenc (ed.) (2020): *A közigazgatási eljárás szabályai I. Az általános közigazgatási rendtartás magyarázata* [Rules of administrative procedures. Commentary for practice, explanation of general public administration procedures, 4th edition, Book I], 19. HVG-ORAC Lap és Könyvkiadó Kft., Budapest, 2020 (hereinafter: Ákr. Commentary, 2020).

5 Ákr. Commentary, 2020:19–20; cf also: Boros, Anita (2019): A közigazgatási eljárás és eljárásjog fogalma és rendszere [Concept and system of administrative procedures and procedural law], in Boros, Anita – Darák, Péter (eds.) (2020): *Az általános közigazgatási rendtartás szabályai* [Rules of general public administration procedures]. Budapest: NKE, https://antk.uni-nke.hu/document/akk-uni-nke-hu/Az%20%C3%A1ltal%C3%A1nos%20k%C3%B6zigazgat%C3%A1si%20rendtart%C3%A1s%20szab%C3%A1lyai_190128.pdf Downloaded on 16 March 2022 (hereinafter: Boros, 2019), 8.; Balogh-Békési, Nóra (2019): A közigazgatási eljárásjog alapelvei, hatályai [Principles and scope of public administration procedural law], in: Rules of general public administration procedures, edited by: Boros– Darák (2019), op. cit., downloaded on 16.03. 2022 (hereinafter: Balogh-Békési, 2019), 34–35.

6 Ákr. Commentary, 2020:19–20; cf also: Boros, 2019:8.; Balogh-Békési, 2019:34–35.

Table 1
The provisions of Ákr to be applied in MNB official procedures

	The relevant rules of Ákr shall be applied
1.	to the role of principles, to the principle of legality, to the principle of responsibility for the procedure, to the principle of efficiency, to the principles relating to customers, to the principle of good faith and to the principle of trust,
2.	to procedural ability and representation,
2a.	to procedural obligation identified in Section 15 (2),
3.	to the assessment of scope and jurisdiction,
4.	to the rules of request,
5.	to data management, the closed handling of data,
6.	to the procedural protection of minors, the incapacitated or partially incapacitated persons of age or persons with disabilities,
7.	to patrons,
8.	to the participation of special authorities,
9.	to the application for restitutio,
10.	to the general rules of summoning a witness and the obligation of the summoned to appear,
11.	to the clarification of facts, to calling a customer to make a statement,
12.	to witnesses, to inspections, to experts, to interpreters, to the presentation of evidence to customers,
13.	to recording of procedural acts, to official witnesses,
14.	to the general rules of notification of decisions, to delivery agents,
15.	to the adjustment of decisions, to complementing decisions,
16.	to official certificates, IDs and registers,
17.	to seizure and requisition,
18.	to legal remedies except for appeals, and supervisory procedures, to the general rules of the cost of proceedings,
19.	payment of the costs of proceedings, advance payment of the costs of proceedings and decisions on advance payment of the costs of proceedings.

It is clear from the above list that legislators allow the application of Ákr provisions in MNB official procedures in cases that are sufficiently general to be applied. Next, let us review the specific procedural legal institutions and concepts of market surveillance procedures.

2.2 Customers in market surveillance procedures

In addition to the MNB, customers are the other indispensable players of market surveillance procedures similarly to other public administration procedures. Section 47(1) of the Central Bank Act provides, "In the MNB's authorisation, inspection, consumer protection inspection, market surveillance procedure, during its supervisory inspection, and in the procedure specified in point f) of Section 45, a customer is,

a) for whom the MNB may establish rights and obligations,

b) who is subject to the control of MNB,

c) who submits an application for authorisation to the MNB,

d) who, as a consumer, submits a request for the conduct of a consumer protection control procedure, or

e) for whom the official register maintained by the MNB contains data."

Naturally, the above list defines the concept of customer in general terms with respect to the official procedures of the MNB, so not all points of the list can be interpreted for market surveillance procedures.

Considering that Section 90 (1) of the Central Bank Act starts with, "The MNB initiates a market surveillance procedure…", that type of procedure is deemed official, which commences either based on a natural person's application, or because of a report by an authority, or if suspicion arises indicating some irregularity noticed during monitoring by the MNB.[7]

Following the same logic, a customer of the MNB (the term 'natural or legal persons subject to the proceedings' would describe the nature of a market surveillance procedure better in view of its most typical termination), shall be a person for whom the MNB establishes a right or obligation, or who is subjected to surveillance by the MNB.[8]

7 MNB (2014): *Pénzügyi fogyasztóvédelmi és piacfelügyeleti jelentés* [Financial consumer protection and market supervision report]. Budapest: Magyar Nemzeti Bank (hereinafter: MNB market supervision report), 42.

8 Central Bank Act, Section 47 (1), points a) and b)

2.3 Subject and course of market surveillance procedures

The cases for the initiation of market surveillance procedures have been recorded in two passages of the Central Bank Act, first in Chapter V, Section 42, points g) and l), and then in Title 30 on market surveillance procedure, Section 90 (1)

For easier understanding, the following Table includes the provisions of the two paragraphs side by side.

Table 2
Cases when MNB shall initiate market surveillance procedures

The MNB initiates a market surveillance procedure	
Central Bank Act, Section 42, points g) and l)	Central Bank Act, Section 90 (1)
if it detects an activity carried out without a licence or in absence of notification.	a) in the event of suspicion of financial services, supplementary financial services, Stock Exchange, Commodities Exchange, asset fund management, CSD services, mutual society, private pension fund, insurance, reinsurance, occupational pension provider, investment services, supplementary services, mediation (agency) services carried out without a licence or in absence of notification.[1]
in case of detection of activity carried out without a license or in the absence of notification; in case of suspicion of insider trading or market influence (hereinafter including insider trading and market manipulation as described in Articles 37-42 of Commission Regulation 1031/2010/EU); for the purpose of checking insider reporting and disclosure requirements.	b) in the event of suspicion of insider trading or market manipulation, or unauthorised disclosure of insider information.
for the purpose of reporting and disclosure obligation of an insider person.	c) for the purpose of inspecting the rules related to managers and persons closely related to them pursuant to Commission Regulation No 596/2014 (EU), and in given cases for disclosure obligations of persons closely related to them pursuant to Commission Regulation No 596/2014 (EU).
inspects if the rules and principles related to acquisitions in public limited companies are observed.	d) for the purpose of inspecting the rules of corporate acquisition.
further, for the purpose of inspecting if the rules related to reporting and disclosure obligations provided in Sections 5-8 of Regulation No 236/2012/EU of the European Parliament and of the Council and to controlling unsecured transactions in Sections 12-14 are observed.	e) for the purpose of inspecting if the rules related to reporting and disclosure obligations provided in Sections 5-8 of Regulation No 236/2012/EU of the European Parliament and of the Council and to controlling unsecured transactions in Sections 12-14 are observed.

9 Point [35] of Order No Kfv.35.642/2016/6 by the Curia as Court of Appeal, cf also Point [38] of Order No Kfv.35.588/2016/10 by the Curia as Court of Appeal; point [33] of BH 2019.281, and Point [33] of Order No 35.220/2018/9 by the Curia as Court of Appeal

As one can see, the MNB market surveillance procedures are activity-based, i.e., they are related to financial services or activities, investment services or mediating activities that are, in certain cases, subject to a licence by the Supervision on, in other cases, the MNB must be notified.[10] Market surveillance procedures are, on the one hand, initiated in the absence of notification to the MNB or, on the other hand, if such unlawful activities are carried out. This can be explained because in the event of an abuse of the capital market (e.g., insider trading) it is unlikely that a licence has been applied for or the MNB has been notified. Studying the actual activities is not subject matter for this paper, since it is focused on the aspect of procedural law rather than of substantive law related to market surveillance procedures.

Regarding the connection between market surveillance and inspection procedures, it should be noted that the rules of inspection procedures are in Title 27 of the Central Bank Act while those governing market surveillance procedures are in Title 30.[11] Regarding market surveillance and inspection procedures, the former allow more "playing field" for the MNB, because "carrying them out or requirements of disclosure are not necessarily linked to the inspection of certain authority decisions, observation of legal provisions or a single customer"[12]

The legal provisions about conducting market surveillance procedures were significantly changed in 2018, when the regulation about processing time was modified as follows: Section 90 (2) of the currently effective Central Bank Act provides, "in the market surveillance procedure specified in points a)–d) and f) of paragraph (1), the administrative deadline starts from the date of initiation of the inspection ex officio and lasts for

a) six months to conduct the official inspection procedure, and
b) in the event of a violation of the law, an additional three months to conduct the official procedure."

In view of the regulation, a market surveillance procedure can be divided into two phases. The first is an official inspection procedure, and the second one, in case the Supervision establishes a violation of law, is a procedure by the competent authority. The former lasts for six and the latter for three months, so the processing time for market surveillance procedures is nine months in total, as a general rule, starting from the date of initiation of the inspection ex officio, which

10 Babai-Belánszky–Barnóczki–Kardos, 2017:906–907.

11 BH 2017. 248. [24]; cf also: Order No kfv.35.761/2015/8, [29] of the Curia as Court of Appeal

12 Kálmán, János (2016): Administrative law aspects of the macroprudential regulation and supervision of the financial intermediary system – normativity, organisation, toolkit. In: *Financial and Economic Review*, 15(3), 27–50.

does not include the time of conducting certain procedural steps,[13] for instance, contacting a foreign authority, the duration of proceedings by the relevant authorities, or the time an expert opinion is prepared.

2.4 Specific procedural actions of market surveillance procedures.

During a market surveillance procedure, the MNB can utilise all available evidence to clarify the legal situation and to reveal a customer's activities as accurately as possible.[14] In this study, the special procedural actions and legal institutions are presented only. They include on-site search, temporary measures, and delivery. Although the latter two are not unique, they can be seen to be specific compared to general rules.

On the other hand, on-site search/inspection is a legal concept to be found in Title 27 of the Central Bank Act alone. In view of this, the rules of on-site search will be discussed in this part of the paper. Accordingly, the following can be established regarding the analysis of on-site searches with respect to time, space, and method.

The outstanding importance of on-site search and the depth of how it intervenes with privacy is indicated by the fact that, in some cases, it is subject to the prior approval of the Court,[15] and the Supervision may request police assistance to carry it out.[16] On-site search is subject to Court approval if it is carried out against the will of the owner, holder or the person staying at the premises, or if it necessitates opening a closed area, building or room.[17] An important rule of guarantee provides that an on-site search can only be carried out within fifteen days from notification of the Court approval,[18] so that the MNB could not use the opportunity unlimited in time.

It can occur that the officers of the MNB find evidence during an on-site search subject to Court approval, which is not related to the subject of the market surveillance procedure in question nor is it covered by Court approval, still, it is considered a reason for initiating market surveillance proceedings. In such a case a copy of the evidence may be made, it can be confiscated or seized.[19] Judicature has

13 Central Bank Act, Section 49 (4)

14 Babai-Belánszky–Barnóczki–Kardos, 2017:909.

15 Central Bank Act, Section 90/A (3); cf also Babai-Belánszky–Barnóczki–Kardos, 2017:909..

16 Central Bank Act, Section 90/A (1); cf also Babai-Belánszky–Barnóczki–Kardos, 2017:909.

17 Central Bank Act, Section 90/A (1); cf also Babai-Belánszky–Barnóczki–Kardos, 2017:909.

18 Central Bank Act, Section 90/A (5); cf Babai-Belánszky–Barnóczki–Kardos, 2017:908.

19 Central Bank Act, Section 90/A (9)

an important part to play in that case too, since a subsequent Court approval must be obtained within fifteen days from the on-site search, otherwise the evidence found cannot be used as proof.[20]

Regarding the time horizon of an on-site search, the Central Bank Act provides it must be carried out on workdays between eight and twenty hours, unless another time is justified by the successful execution of the inspection.[21] An on-site search is always linked to a market surveillance procedure, as the market surveillance procedure must be started at the same time as the on-site search is commenced.[22] It also means no on-site search can be carried out outside or prior to a market surveillance procedure. In view of the purpose of the legal provision, the customer or, if the customer is a legal entity, the customer's employee, [23] or the person on site must be informed of the fact of starting an on-site search at the site (the latest).[24] The reason for this provision is that an earlier notification could jeopardise the success of the inspection.

Where can an on-site search be carried out? Actually, almost anywhere, since the Central Bank Act provides as a main rule that, to clarify the facts, an on-site search for evidence linked to potential legal violations can be carried out at any place where evidence can be found.[25] This provision is supplemented in the Central Bank Act, Section 90/A, paragraph (2), which provides "an on-site search is also possible at real estate, in vehicles and data carriers that are not declared as the customer's residential address, seat or business location, or for private use". [26]

On-site search of the latter places, however, is only possible if "they are used by a natural person who is a customer during the procedure, or - in the case of a non-natural person - the customer's senior official, employee or agent or - in the case of a non-natural person - the person who actually exercises control over the customer or was such during the period covered by the investigation."[27]

With respect to the method of an on-site search, the Central Bank Act provides, "an on-site search must be carried out in such a way that it does not result in a disproportionate restriction of the private life of the person concerned, and that it

20 Central Bank Act, Section 90/A (9) and (10)

21 Central Bank Act, Section 90/A (8)

22 Central Bank Act, Section 90/A (6)

23 Central Bank Act, Section 90/A (6)

24 Central Bank Act, Section 90/A (7)

25 Central Bank Act, Section 90/A (1)

26 Central Bank Act, Section 90/A (2)

27 Central Bank Act, Section 90/A (2)

does not hinder the work and intended activities of the person concerned."[28] During an on-site search, the presence of the person affected is important, but their absence will not prevent conducting it. If they are absent, and their presence cannot be ensured, the cooperation of an official witness can be used[29], in which case the relevant provisions of Ákr shall apply.[30] From the aspect of the authorities, it is better if the person affected is present during an on-site search, because "during the on-site search, the person conducting the research can oblige the affected parties to provide information and explanations orally or in writing, and can obtain information in other ways on-site."[31]

The detailed, mostly technical provisions in the Central Bank Act, Section 90/B and 90/C relating to evidence - data carriers, seizure copies, examination working copies, closed storage device - will not be presented here. It should be noted, however, that in July 2016 the MNB was among the first of Hungarian administrative authorities to receive statutory powers to prepare physical copies (mirror the contents), which means in practice that copies can be made from computers, smart phones or any other data carriers in which data can be restored even if they have been deleted.[32] The Supervision cannot only make such copies during on-site search but also during on-site inspection.

In addition to on-site search, temporary security measures are also among the special rules of market surveillance. Ákr provides the relevant general provisions. Procedural law provides that temporary security measures can be applied if "it can be reasonably assumed that there is a risk of non-fulfilment of the obligation imposed in the substantive decision."[33] The general rule is supplemented with specific elements in the chapter of the Central Bank Act about the common regulations of authority procedures and a provision in a point related to market surveillance.

28 Central Bank Act, Section 90/A (8)

29 Central Bank Act, Section 90/A (7)

30 Central Bank Act, Section 46 (2), point 13

31 Central Bank Act, Section 90/A (7)

32 Babai-Belánszky–Barnóczki–Kardos, 2017:909.

33 Law CL of 2016 on general administrative regulations, Section 107 (4), cf also: Vértesy, László – Boros, Anita – Pfeifer-Tóth, Tamara (2019): A kérelemre induló eljárás [Application-based procedures] in: Boros–Darák (2019): op. cit. 115. https://antk.uni-nke.hu/document/akk-uni-nke-hu/Az%20%C3%A1ltal%C3%A1nos%20k%C3%B6zigazgat%C3%A1si%20rendtart%C3%A1s%20szab%C3%A1lyai_190128.pdf (downloaded on 16.03.2022).

Table 3
Cases when the MNB orders temporary measures

The MNB can order a temporary security measure if	
Central Bank Act, Section 49/D (3)	Central Bank Act, Section 93 (4)
a) it is urgently necessary due to the protection of the legal or economic interests of the interested parties,	to ensure collection of market surveillance fines, or
b) to ensure the protection of the customers of the person or the financial organisation subject to supervision carrying out an activity without a license or in absence of notification,	to ensure the protection of the interests of the customers of the person or financial organisation carrying out activities without a licence or in absence of notification
justifies such measures.	

The above *Table 3* indicates that the rules of temporary security measures applicable by the MNB during administrative procedures and those of temporary security measures applicable during market surveillance are almost identical, however, in this case the financial organisation supervised is not included in the definition. The MNB issues an independent non-appealable order for temporary security measures,[34] to order "freezing money or financial assets, prohibition of alienation or encumbrance with respect to other movable or immovable assets"[35]

As legislators provided in Ákr, a temporary security measure is in effect until a substantive decision is made. Following a substantive decision, the MNB may order a security measure for its execution, which comprises of the same measures as the temporary security measure.[36] A security measure can also be ordered so that a decision made in a market surveillance procedure could be executed.[37]

The Supervision shall inform the affected financial institutions about both security and temporary security measures directly so that they can be executed as soon as possible.[38] Naturally, the justification for conducting either of them is to pro-

34 Central Bank Act, Section 49/D (1)

35 Central Bank Act, Section 49/D (4)

36 Central Bank Act, Section 49/D (4), cf also: Pfeifer-Tóth, Tamara – Iván, Dániel (2019): Az egyes hatósági intézkedések különös szabályai [Application-based procedures, in Boros–Darák (2019), op. cit. 205. https://antk.uni-nke.hu/document/akk-uni-nke-hu/Az%20%C3%A1ltal%C3%A1nos%20k%C3%B6zigazgat%C3%A1si%20rendtart%C3%A1s%20szab%C3%A1lyai_190128.pdf (hereinafter: Pfeifer-Tóth–Iván, 2019) (downloaded on 16.03.2022).

37 Central Bank Act, Section 93 (4)

38 Central Bank Act, Section 93 (4)

vide enhanced protection for investors if the customer of a market surveillance procedure might be found guilty of violating the law. The MNB shall publish an order that has resulted from such measures of preventive nature on its website - not in every case, for instance, in the event a bank account is blocked, bank secrets must be considered - to reach as many of potentially harmed persons as possible, and also to prevent further people being affected by a customer's unlawful activities.[39] In most cases, the activities are banned until a decision is made.

The Supervision pays particular attention to prevention not only during a market surveillance procedure but also in other cases. That is the why a so termed "warning list" is managed. Its purpose is to provide investors with updated information about persons or organisations suspected of conducting activities without a licence or in absence of notification.[40]

2.5 Data available in a market surveillance procedure and their management

The data available to the MNB during a market surveillance procedure can be categorised in several ways. One can differentiate, on the one hand, by the mode of storage (data on electronic data carriers or in hard copies), on the other hand, by the persons affected by the data, (a customer, a natural person potentially in possession of further evidence with respect to the market surveillance procedure), or by the source of the data, (linked to payment accounts, securities accounts or electronic telecommunication devices).[41]

However, the most important criterion of categorisation of data available during a market surveillance procedure - in line with the Central Bank Act - is whether they require prosecutor's approval for the MNB. It can be considered a main criterion of categorisation because Title 30 on market surveillance of the Central Bank Act placed the provisions related to data in two separate paragraphs according to that - Section 90, paragraphs (3)-(5) and Section 91. In everyday practice, however, the MNB will obtain prosecutor's approval before requesting disclosure in almost every case.

Prosecutor's approval needs not be obtained to have access to the data regulated in the Central Bank Act Section 90 (3) and (4). In such cases, "a person or organisation subject to the provisions of the Central Bank Act Section 39 (1) and (2)

39 Babai-Belánszky–Barnóczki–Kardos, 2017:910.

40 Babai-Belánszky–Barnóczki–Kardos, 2017:910.

41 Babai-Belánszky–Barnóczki–Kardos, 2017:908.

shall forward, called on by the MNB including the reason and purpose, the data they process linked to the customer of a market surveillance procedure or to the case."[42] Credit institutions, financial enterprises, housing savings banks and other persons or organisations subject to MNB surveillance have obligation to cooperate.[43]

What does that obligation cover? It should be noted that the right to avoid self-incrimination known from criminal law is also present in market surveillance procedures, which means a "suspected violator" is not obliged to make a declaration admitting a potential violation of law.[44] On the other hand, the subjects identified in law shall "present documents, electronically recorded data, signals, recorded telephone conversations, provide other information, and hand over personal data the MNB is authorised to process pursuant to a specific law."[45] As regards access to data, the Supervision has additional powers during a market surveillance procedure. Although Law CXLI of 1997 on the real estate register, Section 70 (1) cannot be applied, the relevant powers can only be exercised to the extent necessary for the market surveillance procedure.[46]

The provision cited includes a restriction, according to which "natural personal identification data, or personal identifiers may not be used for the purpose of determining all the owner's properties from the real estate register or providing information about them."[47] Pursuant to the Central Bank Act, however, the Supervision can - during a market surveillance procedure - obtain information about an owner's all real estate, which is significant from the aspect of legal consequences or potential subsequent criminal proceedings.

The Central Bank Act includes strict rules about the management of personal data obtained unless they are subject to prosecutor's approval. The Supervision may process personal data until the conclusion of the official inspection, if the MNB has not initiated official proceedings or criminal proceedings based on the inspection, or in the procedural phase, during the official procedure until the execution of the ordering decision or until the expiration of enforceability, or, in the case of court proceedings related to the market surveillance procedure, until their final conclusion.[48]

42 Central Bank Act, Section 90/A (3); cf also Babai-Belánszky–Barnóczki–Kardos, 2017:909.

43 Central Bank Act, Section 39 (1) and (2)

44 Babai-Belánszky–Barnóczki–Kardos, 2017:909.

45 Central Bank Act, Section 90 (3), points a), b), and c).

46 Central Bank Act, Section 90 (4)

47 Law CXLI of 1997 on the real estate register, Section 70 (1).

48 Central Bank Act, Section 90 (5)

The provisions related to data subject to prosecutor's approval are included in the Central Bank act, Section 91. This can be rightly interpreted as a provision of the market surveillance procedure strengthening its criminal law side, since it is infrequent in Hungarian law that public authorities can have access to the data regulated here during their procedures.

Table 4
Data to be learnt during a market surveillance procedure requiring prosecutor's approval[49]

To fulfil its duties, during its market surveillance procedure, the MNB shall be authorised to learn and process data related to the customer subject to the procedure or subject to the customer's right of disposal
a) related to securities, customer and payment account transactions, the number and owner of the account to be debited and credited, the legal title of the debit and credit and the payment identification code of the transfer,
b) related to the number of other identifiers of the subscriber station owned or used by the customer, the calling and called subscriber numbers, as well as the date and start time of the call and other service, as well as the subscriber's family and regarding their surname, birth name, place of residence, place of stay,
c) necessary for the identification of a natural person known based on the turnover of the payment account and securities account of the customer subject to the procedure, who probably has additional evidence from the point of view of the market surveillance procedure

The Supervision must be incredibly careful if they want to learn the above data, since pursuant to the Central Bank Act, prosecutor's approval is subject to strict conditions, and the prosecutor's office will refuse approval if the conditions are not met.[50] The MNB is obliged to demonstrate that the data is necessary. Although it is not an exact legislative concept, it provides some indication for the request. Such grounds are if the data is necessary to fully clarify the facts or to learn about other relevant facts linked to the actions being the subject of the procedure.[51]

The rules related to processing such type of data are different from those in the Central Bank Act, Section 90 (5), since the Supervision may process them for five years from the conclusion of the official inspection, or - in the case of the initia-

49 Central Bank Act, Section 91 (1)

50 Central Bank Act, Section 91 (4)

51 Central Bank Act, Section 91 (2)

tion of official proceedings - from the decision or the order terminating the proceedings becoming final, or from the final conclusion of any court proceedings initiated in connection with the market surveillance procedure.[52]

2.6 Legal consequences to be established during a market surveillance procedure

In its 2014 market supervision report, the MNB declares, "the purpose of market surveillance procedures is to ensure uniform, predictable and consistent policy of market surveillance measures and sanctions."[53] Accordingly, the legal consequences applicable by the Supervision have been identified so that "they can guarantee sufficient deterrent effect from activities generating market deviance and effective detection of market abuse for all players in the money and capital markets"[54]

The relevant provisions of the Central Bank Act divide the legal consequences to be established during a market surveillance procedure into two parts on the basis whether the activity was conducted without a licence or in absence of notification. The same categories were already used at the time of the operation of the State Supervision of Financial Institutions (PSZÁF), so the regulation has not changed in this respect since 2013.[55] For easier understanding, the Figure below illustrates the legal consequences in the above breakdown.

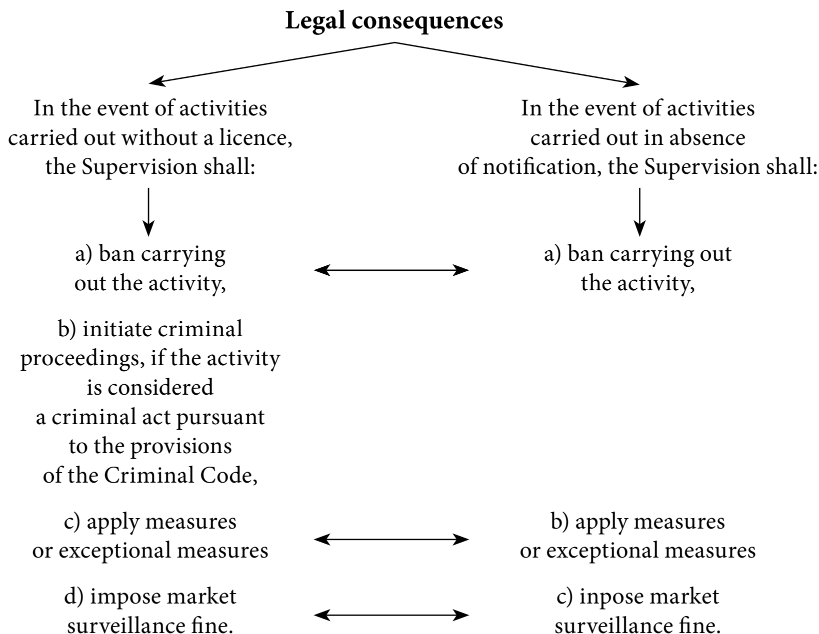
52 Central Bank Act, Section 91 (6)

53 MNB market supervision report, p. 42.

54 MNB market supervision report, p. 42.

55 Seregdi, László (2013): A PSZÁF jelenlegi helyzete, szerepe, a várható, illetve indokolt változások [Current position of PSZÁF, its role, expected and justified changes], in: Prof. Dr. Lentner, Csaba (ed.) (2013): *Bankmenedzsment, bankszabályozás, pénzügyi fogyasztóvédelem* [Bank management, bank regulation, financial consumer protection]. Budapest: Nemzeti Közszolgálati és Tankönyv Kiadó, 414. (hereinafter: Seregdi, 2013).

Figure 1
Legal consequences to be established during a market surveillance procedure[56]



As you can see, three of the legal consequences are the same, the only difference is linked to the initiation of criminal proceedings the MNB shall apply in the event of a customer's activity carried out without a licence and only in case the Supervision considers the activity to be a criminal act pursuant to Law C of 2012 on the Criminal Code.[57]

The MNB also reviews during a market surveillance procedure if the obligations resulting from EU law are complied with. Accordingly, if it detects a violation of the notification obligations stipulated in Regulation 236/2012/EU of the European Parliament and of the Council, Sections 5-8, it shall obligate the person or organisation defaulting to comply.[58] In the same way, if the Supervision establishes violation of the provisions related to restrictions on uncovered transactions stipulated in Sections 12-14 of the above EU Regulation, it shall call on the person

56 Central Bank Act, Section 93 (1) and (2), cf also: Seregdi, 2013:414.

57 Central Bank Act, Section 93 (1), cf also: Seregdi, p. 414.

58 Central Bank Act, Section 93 (3), point a)

or organisation to comply with the conditions.[59] The MNB shall impose a market supervision fine in both cases in addition to the legal consequences above.[60]

In addition to initiating and conducting criminal proceedings, imposing market supervision fines in market surveillance procedures - considering their upper limit - seem to be the most powerful deterrent from conducting similar activities in future. It should be underlined that pursuant to the Central Bank Act, Section 93 (1), point d) and Section 93 (2), point c), in the event that activities carried out without a licence or in absence of notification are established, the MNB has no discretion with respect to a market supervision fine as the legal consequence to be applied.[61]

The Curia as Court of Appeal also declared the same in 2018. On the other hand, the actual amount of market supervision fines is at the discretion of the MNB matching the measure and weight of the illegal activity in question and observing the lower and upper limits pursuant to the Central Bank Act, Section 93 (5) and (5a). The following Table includes the amount of fines to be imposed on legal violations established. It is clear the range open for the MNB with respect to market supervision fines is wide, as the lower limit is HUF hundred thousand, while the upper limit can be as high as HUF 4.67 billion.

59 Central Bank Act, Section 93 (3), point b)

60 Central Bank Act, Section 93 (3), point c)

61 BH 2019.281. [43]; cf also: Order No kfv.35.220/2018/9, [43] of the Curia as Court of Appeal

Table 5
Market supervision fines to be imposed during a market surveillance procedure[62]

Market supervision fines to be imposed during a market surveillance procedure	
Legal violation established	Amount of fine to be imposed
on activities carried out without a licence or in absence of notification	can be from HUF hundred thousand to HUF two billion;
on violating the rules related to company acquisition,	can be from HUF hundred thousand to HUF two billion;
on violating the provisions of Law CXX of 2001 on the capital market (hereinafter: Tpt), Section 405 (3) and (4)	can be up to the amount provided in Tpt, Section 405 (3) and (4), which is up to HUF two billion, or HUF 4.67 billion in certain cases.
on violating the rules related to reporting and disclosure obligations provided in Sections 5-8 of Regulation No 236/2012/ EU of the European Parliament and of the Council and to controlling unsecured transactions in Sections 12-14	can be from HUF hundred thousand to HUF two billion;
In the case the customer is not a natural person, the natural person contributing to the activity subject to a market supervision fine,	the amount of the fine to be imposed can be in a range of HUF hundred thousand to HUFM 100 in addition to the application of the provisions of Section 93 (5).

The last line of the *Table 5* is most interesting and worth attention. It generates a break through the civil liability of a legal entity by providing that during market surveillance a market supervision fine can also be imposed on a person contributing to the activity of a legal entity. The provision applicable since July 2015 has been included in the Central Bank Act, because natural persons often wilfully carried out illegal financial activities hidden behind and making use of the limited liability of legal entities.[63]

Earlier, the Supervision did not have the right to take action against a "natural person contributing" in proceedings initiated against a legal entity during market surveillance. The above provision settles the issue. Accordingly, a market supervision fine can be imposed on a natural person if "they held an initiating, control-

62 Central Bank Act, Section 93 (5) and (5a)

63 Babai-Belánszky–Barnóczki–Kardos, 2017:911

ling or organising function - beyond simple participation - in the establishment and operation of illegal activity, and the illegal activity could not have been conducted or could only have been conducted at a much smaller scale without their violation of the law."[64] In such a case, the market supervision fine imposed on a natural person is fairly high, its amount can be in a range from HUF hundred thousand to HUFM 100.[65]

Finally, the MNB may apply publication on its website as a legal consequence in the event a market supervision fine is imposed, or if it orders the prohibition of the further continuation of unlawful behaviour, or orders the termination of an unlawful state due to the activities carried out without a licence or in the absence of notification if "it is necessary to protect the legal or economic interests of the clients of the person or organisation conducting the activity without a licence or in the absence of notification, or to protect public interest".[66]

In such a case the number and subject of the decision establishing a violation of law, the family and first name and the address of the natural person who violated the law, and the name and headquarters of the infringing legal entity or organisation without legal entity as well as the operative part of the decision become public and accessible for a year from the date of publication.[67] Publication is a very important legal consequence for prevention. Its application may reduce the number of future violations of law and of injured parties.

3 SUMMARY: THE CONCEPT OF MARKET SURVEILLANCE PROCEDURES

In accordance with the goals set in the Introduction, the conceptual components of market surveillance procedures by the MNB can be defined as follows.

As regards the structural position of market surveillance procedures, one can state it is a special procedure of public administration that belongs among the micro prudential surveillance of the MNB resulting from its basic tasks of surveillance of the financial mediation system. Resulting from the nature of administrative procedures, the person or organisation affected by the procedure is the customer.

Considering that market surveillance is deemed an administrative procedure, it is subject to Ákr. At the same time, the MNB official procedures are deemed to be outside scope, which means those types of procedures - as a rule, in general and

64 Babai-Belánszky–Barnóczki–Kardos, 2017:911

65 Central Bank Act, Section 93 (5a)

66 Central Bank Act, Section 94 (1)

67 Central Bank Act, Section 94 (1) and (2)

primarily - are not subject to the provisions of Ákr. This, however, does not mean the Ákr is completely neglected, as special procedural provisions in the Central Bank Act identify the cases when a general provision of Ákr shall be applied as underlying legislation to a special rule.

Resulting from the provisions of the Central Bank Act, market surveillance is deemed a procedure ex officio, which means the MNB initiates it acting in its role of supervisory authority. Considering that market surveillance procedures initiated because of capital market abuse or unlawful activities related to financial services or activities, investment services or mediating activity that are in certain cases subject to a licence by the Supervision, in other cases to notification to the MNB, they are deemed to be activity-based.

A market surveillance procedure can be divided into two phases. The first is an authority inspection procedure, and the second one - in case the Supervision establishes a violation of law - is a procedure by the competent authority. One can say in general that MNB applies a preventive approach in administrative procedures, accordingly, market supervision procedures do not focus on subsequent sanctions of legal violations but intend to prevent and manage potential future market supervision risks.

The MNB closely cooperates with the investigative bodies during market surveillance, including the police and the prosecutor's office, while the court also plays an important part regarding the evidence obtained during a procedure. To sum up, one can state that market surveillance is a complex but effective, quick, and professional official procedure in the event of suspected capital market abuse and financial activities carried out without a licence or in absence of notification.

Based on the above, the concept of a market surveillance procedure can be defined as follows:
"Market surveillance is a special administrative procedure of preventive nature by the National Bank of Hungary (MNB), during which the MNB shall conduct official control and administrative procedures resulting from its basic task of supervising the financial mediating system in the event of suspected capital market abuse, or financial activities and investment services carried out without a licence or in absence of notification."

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CORRELATIONS BETWEEN THE OUTSOURCING ACTIVITY THAT CAN BE CARRIED OUT BY CREDIT INSTITUTIONS AND THE PROTECTION OF PERSONAL DATA

Judit Lisák[1]

ABSTRACT

In the operation of credit institutions, the legal institution of outsourcing is becoming increasingly important. In the framework of this, credit institutions perform some of their activities for financial reasons, economies of scale, or for other reasons, such as their need for access to new technologies, not independently within their own organizational framework, but with the assistance of an external service provider.[2] In order to comply with prudential requirements, credit institutions shall meet a number of legal and supervisory criteria even if they wish to use the assistance of a third party for any of their activities. However, if the governing regulatory regulations are not in compliance with each other, even just in terms of concepts, it may cause a practical problem for credit institutions, which may unreasonably reduce the efficiency of their activities.

Among its interpretative provisions, Act CCXXXVII of 2013 on Credit Institutions and Financial Enterprises (hereinafter referred to as Hpt.) defines the term of outsourcing: *'outsourcing' shall mean an arrangement where a financial institution enters into an agreement with a functionally independent service provider, by which that service provider performs continuously or regularly the activities related to its financial services or financial auxiliary services or as prescribed by law, involving the management, processing and storage of data, which would otherwise be undertaken by the financial institution itself.*" [Point 58 of Section 6 (1) of Hpt.]. However, in relation to the interpretation of certain factual elements included in the definition of outsourcing, a question may arise as to which legislation is applicable to define the terms „data management, data processing, data storage"? Can data protection laws be used as background legislation for this? If the effective data protection laws are taken into account, does the legislator clearly define the

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2 MNB (2020): A Magyar Nemzeti Bank 7/2020. (VI.3.) számú ajánlása a külső szolgáltatók igénybevételéről, 1. [Recommendation 7/2020 (VI. 3.) of the National Bank of Hungary on the usage of external service providers, 1.]. (Source: https://www.mnb.hu/letoltes/7-2020-kulso-szolgaltato-igenybevetele.pdf; downloaded on: 19/07/2022.)

concept of the Credit Institutions Act for practitioners in accordance with such laws, as well? I will examine these questions in more detail below.

JEL codes: G2, K23

Keywords: outsourcing, data protection, management of personal data, credit institutions

1 APPLICABILITY OF DATA PROTECTION LEGISLATION

The terms „data management, data processing, data storage" included in the above definition of outsourcing are not defined by the Credit Institutions Act. The question therefore necessarily arises, what kind of legislation can be used to interpret these and other related terms (e.g., data subjects)?

Perhaps the most obvious solution seems to be the application of certain provisions of the effective data protection legislation, primarily those of Regulation (EU) 2016/679 of the European Parliament and of the Council of 27 April 2016 on the protection of natural persons with regard to the processing of personal data and on the free movement of such data, and repealing Directive 95/46/EC (hereinafter referred to as the General Data Protection Regulation) and Act CXII of 2011 on the Right of Informational Self-Determination and on Freedom of Information (hereinafter referred to as the Info Act). However, it should be taken into account that the General Data Protection Regulation only contains regulations regarding the management of personal data, therefore it does not apply to the management of other data (e.g., data of legal entities, business secrets that do not qualify as personal data, other protected data, etc.). Accepting the application of the General Data Protection Regulation would therefore also mean that we narrow the range of data to be examined to personal data.

To answer this question, you can use the commentary to the Credit Institutions Act, as well as opinions issued by the National Bank of Hungary (hereinafter referred to as the MNB or Supervisory Authority) containing orientational interpretations of the law in relation to legislation.[3] According to the explanation for outsourcing in the Hpt, since the Credit Institutions Act does not define terms

3 Opinion by the Hungarian Financial Supervisory Authority/MNB: As a result of its regulatory responsibilities, the Hungarian Financial Supervisory Authority issued orientational legal interpretations, i.e. opinions for financial organizations in relation to the relevant legislation. This activity has been carried out by the MNB since 1 October 2013. The purpose of the opinions is to explain the position of the Supervisory Authority in relation to the interpretation of a specific legal provision, so that the person requesting the opinion can formulate his own legal position

related to data management, the data protection law in force at the time of writing the commentary, i.e. the Info Act, shall be considered as governing.[4]

The opinions of the supervisory authority are not completely consistent, but typically the application of the currently effective data protection legislation was/ is considered to be exemplary. The Hungarian Financial Supervisory Authority (hereinafter referred to as the Hungarian Financial Supervisory Authority, which was then authorized to issue opinions for credit institutions in relation to Act CXII of 1996 on Credit Institutions and Financial Enterprises (the old Hpt.), recorded in some of its opinions the expediency of the application of Act LXIII of 1992 on the Protection of Personal Data and the Disclosure of Information of Public Interest (hereinafter referred to as the Avtv.), the then highest-level legislation on data management and data protection.[5,6,7] Later on, the MNB also came to the conclusion several times in its opinions issued in individual cases in connection with the currently effective Credit Institutions Act that the Info Act then in force should be used to define the concept of data management.[8,9]

However, there is also a legal conclusion contrary to the above among the opinions of the MNB. In one individual case, contrary to the opinions referred to

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based on the – non-binding – position of the Supervisory Authority (Source: https://www.mnb.hu/felugyelet/szabalyozas/allasfoglalasok; downloaded on: 19.07.2022.)

4 Gálfalvi–Kovács–Palasikné Kirschner–Seregdi (2016): *Kommentár a hitelintézetekről és a pénzügyi vállalkozásokról szóló 2013. évi CCXXXVII. törvényhez* (Kommentár a Hpt. 68. §-ához) [Commentary to Act CCXXXVII of 2013 on Credit Institutions and Financial Enterprises (Commentary to Section 68 of the Hpt.]. Budapest: Wolters Kluwer.

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6 Hungarian Financial Supervisory Authority: A banktitok átadása a külföldre történő kiszervezés során [Transfer of bank secrets during outsourcing abroad] (Source: https://alk.mnb.hu/data/cms2329697/allasfogl_penzpiac_111227.pdf (downloaded on: 19.07.2022.)

7 Hungarian Financial Supervisory Authority: Mely tevékenységtípusok minősülnek kiszervezett tevékenységnek? [Which activity types are considered outsourced activities?] (Source: http://alk.mnb.hu/data/cms2103240/penz126.pdf; downloaded on: 19.07.2022.)

8 MNB (2017): A Bszt. és a Hpt. kiszervezésre vonatkozó rendelkezéseinek értelmezése [The interpretation of the provisions of Bszt. and Hpt. concerning outsourcing]. (Source: http://alk.mnb.hu/data/cms2454413/tmpF6FC.tmp(14851343).pdf; downloaded on: 19.07.2022)

9 MNB (2016a): Állásfoglalás a hitelintézetekről és pénzügyi vállalkozásokról szóló 2013. évi CCXXXVII. törvény (Hpt.) 68. § (4) és (10) bekezdésében foglalt kiszervezéssel kapcsolatos egyes kérdések vonatkozásában [Opinion on certain issues concerning outsourcing as defined in Section 68 (4) and (10) of Act CCXXXVII of 2013 on Credit Institutions and Financial Enterprises]. (Source: https://alk.mnb.hu/data/cms2447027/tmp2C8A.tmp(13566306).pdf; downloaded on: 19.07.2022)

earlier, the MNB stated that *"when assessing outsourcing, the MNB - in the absence of a definition in the Hpt. - uses data protection regulations and certain definitions only with regard to the nature and technology of data management, regardless of the fact that the scope of the Info Act only covers the protection of the data of natural persons"*.[10] In my opinion, it appears that the MNB's statement in this particular case is not fully in line with the regulations laid down in the Hpt., the Info Act and the GDPR, or with other MNB opinions. Possible doubts about the correctness of the quoted statement are further confirmed by the fact that the MNB cites, seemingly ignoring the provisions in Section 2 (2) of the Info Act, the concept of data management defined in point 10 of Section 3 of the Info Act as a relevant legal provision from the point of view of the investigation of the facts, to which, however, the provisions of the GDPR shall be applied instead of the Info Act.

In view of the above, in my opinion, the current data protection legislation in force can and should be used as background rules for the interpretation of the definition of outsourcing.

2 ASSESSMENT OF THE CONCEPT OF OUTSOURCING IN THE LIGHT OF THE GDPR

I explained above why I consider data protection legislation to be applicable when interpreting the definition of outsourcing. In the following part of my study, I will examine the extent to which certain factual elements appearing in the concept of outsourcing, which are relevant in terms of data protection and law, can be reconciled with the effective data protection legislation, for which I also consider it important to briefly present the evolution of the relevant legal environment.

2.1 The emergence of the legal institution of outsourcing in domestic legislation

With regard to financial institutions, the legal institution of outsourcing appeared in the old Hpt. for the first time on 1 January 2001, when the concept of outsourcing was included in the interpretive provisions of the act by means of an amend-

10 MNB (2019): A kérelmező (Bank) állásfoglalás iránti kérelemében (Beadvány) a hitelintézetekről és a pénzügyi vállalkozásokról szóló 2013. évi CCXXXVII. törvény (Hpt.) 68. §-ának értelmezése kapcsán fordult az MNB-hez (In its request for opinion [Application), the applicant (Bank) contacted the MNB in connection with the interpretation of Section 68 of Act CCXXXVII of 2013 on Credit Institutions and Financial Enterprises (Hpt.)]. (Source: https://alk.mnb.hu/data/cms2464305/tmp7AD3.tmp(17613425).pdf; downloaded on: 19.07.2022.)

ment to the act [Point 41 of Chapter III of Annex 2 of the old Hpt.]. In addition, the requirements related to the announcement to the Supervisory Authority, the content elements of the outsourcing contract and other conditions were regulated in a separate section [Section 13/A of the old Hpt.]. At the time, the definition of outsourcing was the following: *„outsourcing: when a credit institution does not itself perform the administrative activities in connection with services, but rather entrusts a separate, organizationally independent business association with performing these activities."* In the beginning, therefore, outsourcing referred to the provision of administrative activities, the person performing outsourcing could only be an independent business association, and the definition did not contain data protection provisions.

However, the amendment to Section 13/A of the old Hpt., effective from 1 January 2003, already stated that *„In due observation of the provisions on data protection, credit institutions shall be authorized to outsource financial services and activities auxiliary to financial intermediation as well as those mandatory activities prescribed by law that involve the management, processing and storage of data."* Therefore, the range of activities which can be outsourced was amended, which could no longer only apply to administrative activities, but also to activities related to financial and auxiliary financial service activities or activities prescribed by the law.

The concept also included the condition that data management, data processing or data storage shall be carried out during the performance of the activity. In addition, the requirement that this type of activity could only be organized *„In due observation of the provisions on data protection"* was clearly stated. The justification for the amendment to the law regarding outsourcing was as follows: *„The law re-regulates the provisions on outsourcing which have hitherto been inapplicable in practice. Accordingly, outsourcing can only be interpreted as an activity during which data management, data processing or data storage is carried out continuously or regularly."*[11] However, the terms of data management, data processing and data storage were not even defined in the old Hpt. In practice, according to the opinions of the Hungarian Financial Supervisory Authority referred to earlier, it was advisable to apply the concepts defined in Avtv.[12]

11 Egyes pénz- és tőkepiaci tárgyú törvények módosításáról szóló 2002. évi LXIV. törvény indokolása a 10. §-hoz [Justification by Act LXIV of 2002 on the amendment of certain laws relating to money and capital markets to Section 10].

12 It is interesting to mention that in the Guidelines No. EBA/GL/2019/02 published by the European Banking Authority on 25 February 25 2019 (which the MNB took into account during the drafting of Recommendation No. 7/2020 (VI.3.) on the use of external service providers), the concept of outsourcing does not include a condition regarding data management either, therefore

The importance of the examination of outsourcing by credit institutions regarding data protection and the lack of consistency between the laws were already evident within a short time after the legal institution appeared. In 2004, the data protection commissioner ex officio initiated an investigation to establish that - among other laws - the provisions of the old Hpt. on outsourcing, amended in 2003, were incompatible with the provisions of data protection legislation. The data protection commissioner - among other things - saw the problem in the fact that *„the data processing is carried out in accordance with the Avtv. is an activity that the data controller has performed by someone else, therefore the outsourcing of data processing cannot be interpreted based on the rules of the Avtv."* The data protection commissioner also emphasized that Hpt. could not provide an opportunity for data processing itself to be outsourced by the credit institution managing the data, given that this would conflict with the provision of the Avtv. described above, which states that the data processor may not use another data processor during the performance of its activities [Section 4/A (2) of the Avtv.].[13]

The effective Act on Credit Institutions - similarly to the old Hpt. - defines outsourcing among the Definitions: "*outsourcing shall mean an arrangement where a financial institution enters into an agreement with a functionally independent service provider, by which that service provider performs continuously or regularly the activities related to its financial services or financial auxiliary services or as prescribed by law, involving the management, processing and storage of data, which would otherwise be undertaken by the financial institution itself*" [Point 58 of Section 6 (1) of the Hpt]. However, in a separate sub-heading on outsourcing, the act states that "*In due observation of the provisions on data protection, credit institutions shall be authorized to outsource the activities connected to financial services and financial auxiliary services as well as those statutory activities prescribed by law that relate to the management, processing and storage of data.*" [Section 68 (1) of the Hpt.]. It is clear that the conjunctive factual elements in the old Hpt., which define outsourcing, can also be found in the currently effective definition: connection to financial or auxiliary financial service activities, or the ordering of the performance of the activity by a law; realization of data management, data

it can be applied to a much wider range: *"an arrangement of any form between an institution, a payment institution or an electronic money institution and a service provider by which that service provider performs a process, a service or an activity that would otherwise be undertaken by the institution, the payment institution or the electronic money institution itself."* Irrespective of the above, in its recommendation, the MNB uses the concept according to the effective sectoral legislation as a basis for outsourcing.

13 ABI (2005): Az adatvédelmi biztos beszámolója (Report of the Data Protection Commissioner), 2004. Office of the Data Protection Commissioner, Budapest, 111–112. (Source: https://www.naih.hu/files/Adatvedelmi-biztos-beszamoloja-2004.PDF; downloaded on: 19.07.2022.)

processing or data storage; the continuity or regularity of carrying out the activity, the contribution of an organizationally independent person.

2.2 Criteria for data management, data processing and data storage

Simultaneously with the coming into force of the General Data Protection Regulation on 25 May 2018, the legislation governing the protection of personal data in Hungary changed such that, thereafter, the provisions contained in the EU Regulation became mandatory as the main rule for the management of personal data. Regarding the processing of personal data falling under the scope of the Regulation, the Regulation shall be applied with the additions listed in Section 2 (2) of the Info Act. Apart from the Info Act, currently, a wide range of sectoral legislation contains regulations regarding the management of personal data.

With the GDPR becoming applicable, the concepts of data processor and data processing have been changed, as well. In the Avtv., data processing as a definition of a form of data management was only mentioned in the concept of data management [Point 4 of Section 2 of the Avtv.], and the person of the data processor was referred to related to the definition of the data controller: *„shall mean a public authority, agency or a legal person which processes personal data or has data processed on its behalf"* [Point 7 of Section 2 of the Avtv.]. Only in later amendments to the law did the legislator clearly define the person of the data controller and the data processor, as well as the concepts of data management and data processing, the latter of which still represented a method of data management and was primarily aimed at performing technical tasks.

Subsequently, according to the version of the text of the Info Act that entered into force for the first time, data processing meant the performance of technical tasks related to data management operations, regardless of the method and tool used to perform the operations, as well as the place of application, provided at the same time that the technical task was performed on the data [Point 17 of Section 3 of the Info Act]. According to the then legislation, data processing meant tasks and operations specifically related to data management, which were of a technical nature, but at the same time were technology neutral.

As of 25 May 2018, the General Data Protection Regulation shall apply to the concepts of data controller and data processor, as well as that of data management. According to the GDPR "*'processor' means a natural or legal person, public authority, agency or other body which processes personal data on behalf of the controller";* [Point 8 of Article 4 of the GDPR]. However, the definition of data processing is not in the Regulation, but from 26 July 2018 - based on Section 2 (2) of the Info Act - it can be found in point 17 of Section 3 of the Info Act: *"data processing' shall*

mean any operation or set of operations which is performed by a data processor on behalf of, or as instructed by, the data controller".

Based on the combined interpretation of these provisions of the GDPR and the Info Act, it can be established that data processing as an operation is synonymous with data management as an operation, that is, the data processor performs data management in the same way, only on the basis of another person's order. None of the laws contains a definition regarding data storage, it is considered a nominal operation of data management. Therefore, in the definition of outsourcing, it is not clear why, in addition to data management, it is necessary to name the operations of data processing and data storage separately.

The listing of certain data management operations in the text of the Act on Credit Institutions can easily lead to unnecessarily narrowing the possible data management operations related to outsourcing by excluding other operations (e.g., collection, recording, transmission, etc.) with this wording. However, this consequence cannot be considered in this case because the concept of outsourcing also includes the general concept of data management, which includes all operations. In addition, at the same time, it is not clear why it is necessary to name data processing and data storage separately in addition to data management among the operations. In my opinion, it is worth removing data processing and data storage operations from the concept of outsourcing in order to bring this part of the Act on Credit Institutions into line with the currently effective data protection legislation.

2.3 The definition of data subjects

The GDPR also includes the concept of „data subject", according to which the data subject is an identified or identifiable natural person (Point 1 of Article 4 of the GDPR). Based on the above, the data subject can be any natural person who is or can be identified on the basis of their personal data. Regarding data processing by credit institutions, the clients of the credit institution (who use financial services provided by the credit institution or contact the credit institution for this purpose [Section 160 (2) of the Hpt.], e.g., debtor, co-debtor, pledgee, etc.), its employees, senior officials, or the representatives and contacts of its contractual partners are typically affected. In the above definition of the Act on Credit Institutions does not narrow the definition to data subjects, therefore the data management, data processing or data storage included in the concept of outsourcing can in principle refer to the personal data of any natural person.

In contrast to this, the commentary to the Law on Credit Institutions states that data management shall specifically refer to the individual data of clients, other-

wise we cannot talk about outsourcing.[14] Earlier, in one of its opinions, the Hungarian Financial Supervisory Authority also[15] narrowly interpreted the concept of data subject, when it came to the conclusion during the evaluation of a specific activity (computer system administration) that *„it is classified as an outsourced activity if, in the course of it, the system administrator actually may come into possession of client data that is considered personal data in accordance with the Data Protection Act.*"

Accordingly, the MNB also consistently considers data management, data processing, and data storage operations to be interpreted only in relation to client data, i.e. it does not refer to the personal data of other natural persons (employees, senior officials, business partners of natural persons).[16,17] In one of its opinions issued in 2019, i.e. after the GDPR became applicable, the MNB expressly stated that: "*…in accordance with Section 68 (1) of the Hpt. the activities connected to financial services and financial auxiliary services as well as those statutory activities prescribed by law that relate to the management, processing and storage of data of the clients of the bank shall be considered to be outsourcing…*". In addition, the opinion lays down that "*the MNB considers all activities involving data manage-*

14 Gálfalvi–Kovács–Palasikné Kirschner–Seregdi (2016): *Kommentár a hitelintézetekről és a pénzügyi vállalkozásokról szóló 2013. évi CCXXXVII. törvényhez* (Kommentár a Hpt. 68. §-ához) [Commentary to Section 68 of the Act CCXXXVII of 2013 on Credit Institutions and Financial Enterprises]. "*Therefore, if the data of credit institution's client is managed, processed or stored during the performance of activities by others, this conceptual element of outsourcing is realized, as well. If during the activity individual client data do not come into the possession of the person performing the activity, we cannot talk about outsourcing.*" Budapest: Wolters Kluwer.

15 Hungarian Financial Supervisory Authority: Mely tevékenységtípusok minősülnek kiszervezett tevékenységnek? [Which activity types are considered outsourced activities?] (Source: http://alk.mnb.hu/data/cms2103240/penz126.pdf; downloaded on: 19.07.2022.)

16 MNB (2017): A Bszt. és a Hpt. kiszervezésre vonatkozó rendelkezéseinek értelmezése (The interpretation of the provisions of Bszt. and Hpt. concerning outsourcing) (Source: http://alk.mnb.hu/data/cms2454413/tmpF6FC.tmp(14851343).pdf; downloaded on: 19.07.2022.)

17 MNB (2016b): Állásfoglalás a bankbiztonsági tevékenységnek a hitelintézetekről és pénzügyi vállalkozásokról szóló 2013. évi CCXXXVII. törvény (Hpt.) szerinti kiszervezéssel kapcsolatos egyes kérdései vonatkozásában [Opinion on certain issues concerning outsourcing as defined in Act CCXXXVII of 2013 on Credit Institutions and Financial Enterprises]. (Source: http://alk.mnb.hu/data/cms2453653/tmp9A4F.tmp(14510620).pdf; downloaded on: 19.07.2022.)

ment, data processing or data storage which affect the data of the bank's clients, i.e., data classified as bank secrets, to be outsourced activities."[18,19]

In my opinion, the position of the MNB is understandable and aligned with the presumed purpose of the law's provisions on outsourcing, as the law presumably prescribes strict rules on outsourcing for credit institutions and those engaged in outsourcing activities, so that clients' personal data can receive even greater protection than under the general rules (considering the fact that these personal data typically are considered sensitive financial data). However, if the assumption is correct, it seems justified to clearly display in the concept of outsourcing that the data management in terms of outsourcing only applies to client data.[20]

In practice, the above-mentioned discrepancy between the Act on Credit Institutions and the GDPR can cause difficulties mostly at the start of the outsourcing activity, i.e., at the classification of the given agreement as outsourcing (whether it is a brokerage agreement or any other agreement). Based on the legislative environment, it is not necessarily clear whether activities that affect the data of employees or other natural persons, but not the data of clients, are considered outsourcing? The importance of classification is not only important because it also determines the exact scope of tasks related to the activity for the credit institution and the external service provider, but the inappropriate categorization of the legal relationship may result in supervisory fines or other sanctions for the credit institution, thus financial and reputational loss.

18 MNB (2019): A kérelmező (Bank) állásfoglalás iránti kérelemében (Beadvány) a hitelintézetekről és a pénzügyi vállalkozásokról szóló 2013. évi CCXXXVII. törvény (Hpt.) 68. §-ának értelmezése kapcsán fordult az MNB-hez [In its request for opinion (Application), the applicant (Bank) contacted the MNB in connection with the interpretation of Section 68 of Act CCXXXVII of 2013 on Credit Institutions and Financial Enterprises (Hpt.)]. (Source: http://alk.mnb.hu/data/cms2464305/tmp7AD3.tmp(17613425).pdf; downloaded on: 19.07.2022.)

19 In relation to the aforementioned opinion of the MNB, it is also worth pointing out that, in the opinion of the MNB, in terms of client data outsourcing, it is irrelevant whether the client is a legal entity or a natural person, which although is in line with the concept of client defined in the rules of bank secrecy, but less so with data protection legislation, especially with regard to the fact that the provisions of the GDPR shall be applied to the concept of data management by the MNB without dispute (as the Hungarian Financial Supervisory Authority also had a similar opinion regarding the applicability of the Avtv. as described above).

20 It should be noted that the concept of client is not defined in the interpretative provisions of the Hpt., as it appears in the law in the provisions on bank secrecy (Section 160 (2) of the Hpt.).

2.4 Continuity or regularity of the performance of the activity

In the concept of outsourcing, an interesting conjunctive factual element from a data protection point of view is the continuous or regular performance of the activity, from which means, at the same time, that the one-time or occasional performance of tasks by an external service provider does not qualify as outsourcing. The reason for this is presumably that, in the case of outsourcing, extremely strict rules must be observed, which would presumably represent a disproportionate burden for the credit institution and the external service provider during the provision of services in an individual case, thus possibly preventing the credit institution from performing the given activity at a higher level, more cost-effectively, or with more advanced technology.

In this regard, however, the question may arise as to whether the condition of continuity or regularity is more reasonable to expect in relation to data management? In fact, it may happen that during the performance of the activity, data management is only carried out on an occasional basis and not continuously or regularly, which does not necessarily justify compliance with the stricter outsourcing obligations from the point of view of risk proportionality. In my opinion, these questions can cause a dilemma for the credit institution in practice, if the credit institution intends to interpret the provisions of the Hpt. by also examining the possible objective goals of the law when evaluating a given activity.

3 SUMMARY

In the above, I examined the relevant factual elements in terms of data protection in the concept of outsourcing and was able to draw the following conclusions. One of the substantive elements of outsourcing - almost since the emergence of the legal institution - is data management (as well as data processing and data storage) carried out during the performance of the outsourced activity. Regarding this element, the highest level of legislation related to data protection and data management, namely the General Data Protection Regulation and certain provisions of the Info Act can be regarded as governing. The current legislation related to data management clearly and accurately defines the terms of personal data, data subject, data management and data processing.

However, in my opinion, the definition of outsourcing in Hpt. is not in line with these data protection concepts in many respects, therefore it is not clear why the legislator specifies data processing and data storage separately in addition to data management, and it is also not clear whether data management applies to all data subjects, or only specifically for natural person clients, and it is questionable

whether continuity or regularity is an essential condition for data processing, or whether it should also be applied to occasional data processing? In my opinion, the above questions can cause not only theoretical but also practical problems for legal practitioners.

As part of the financial sector, credit institutions play an extremely important role in the economy. Their continuous and safe operation from the point of view of the economic actors is therefore a fundamental public and social interest. In order to ensure this, it is necessary to regulate the sector. In addition, it is essential for the credit institutions applying the law and the external service providers they may wish to entrust that the legislation applicable to their activities is transparent, applicable and enforceable. In view of the fact that the lack of conformity between the laws can reduce the efficiency of the operation of credit institutions and cause uncertainty for appliers of the law, the review the current law on credit institutions and the amendment of the concept of outsourcing as necessary in order to ensure transparent and enforceable requirements and to develop uniform practice of law seem to be justified.

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COMPASS TO EUROPEAN ECONOMIC INTEGRATION

Péter Halmai
Európai gazdasági integráció
[European economic integration]

Budapest, 2020
Dialóg Campus Kiadó
Review by Szabolcs Pásztor and Szintia Tamás

The author of this new book clustered around the economic issues of European integration needs no introduction to the readers in Hungary. As a result of his decade-long research on international economics, macroeconomics comparative economics and agricultural economics, Péter Halmai has published many books and papers[1] on the topic. It is not an overstatement that his books were among the first to guide readers through the economic dimensions of the European Union.

Péter Halmai is currently a professor at the Faculty of Economics of the Budapest University of Technology and Economics (BME), and at the University of Public Service (NKE), Faculty of Public Governance and International Studies, Department of Public Finance. Also, he has been a corresponding member of the Hungarian Academy of Sciences (MTA) since 2016 and a regular member since 2022. In recognition of his research on the economic integration of Europe, he has been awarded many prizes, including the Széchenyi Award, the Academy Award, the title of Jean Monnet Professor, and, proposed by the MTA, the Knight's Cross of the Hungarian Order of Merit.

Based on his extensive research and experience, the expectations of Hungarian readers are always running high when Peter Halmai publishes a new book. His most recent book '*Európai gazdasági integráció*' [European economic integration] was published in 2020 by Dialóg Campus clustered around the European integration and European common policies from the aspect of applied economics.

The book is divided into eleven lengthy chapters. As it has been already mentioned, the chapters are grouped to analyse issues such as the theoretical foundations of economic integration, common trade policy, competition policy, the

1 Some books by the author as direct preludes to this volume also discuss overall issues, e.g., Halmai (2013; 2014; 2017; 2019c etc).

common budget of the EU, the common agricultural policy, regional policy, the Economic and Monetary Union, economic policy coordination, fiscal policy, the Stability Pact, the future of the Economic and Monetary Union, the erosion of the European growth potential, and the European Growth Pacts.[2] In this light it is obvious that readers are given a complex view on economic integration. First, the author focuses on relevant categories of the topic of European integration, as they are prerequisites for understanding the whole picture. At the same time, the mosaic reflects an architecture built on strict logic. The different components of the structure fit into tight network. When reading the book, readers get a complex, consistently built picture of the formation of European economic integration.

Chapter one is about the *theoretical foundations of economic integration*. The author highlights the European structure, global and regional integration, the systems of deep, core and differentiated integration (in the author's unique categorisation)[3], the internal market, the impacts of the customs union, the measurement of the impact of economic integration, market size and the economies of scale.[4]

The discussion of European economic integration starts with the definition of the concepts, such as the preferential customs zone, the free-trade zone, the customs union, the common market, and the political union. Readers can grasp the subject much easier following the definitions. Later, the interconnection of globalisation processes and global integration is explained with respect to formerly fragmented markets.

The section on the *internal market* is introduced with the Treaty of Rome of 1958, which had paramount importance in the elimination of trade barriers among the Member States. After that, the author discusses the common market, the internal market, the four freedoms, the symbol of European integration, the focal areas of strengthening the internal market, and the financial services.[5] In addition to revealing in-depth connections, the reviewer believes the clarification of basic concepts is of high importance, since it is quite frequent that an accurate definition of often changing concepts, which would serve better understanding, is missing not only in economic journalism but also in scientific studies. (The section *'Definitions'* highlights the most important terms.)

In the next sub-chapter, the context of the statement „one cannot consider a customs union to be a step towards free trade" is discussed. The impacts of economic

2 Halmai, 2020a:11–13.

3 More on the subject in detail, cf Halmai (2019c, 2020g).

4 Halmai, 2020a:13–46.

5 Halmai, 2020a:13–31.

integration are divided into three measurement categories, a residual model, an econometric model, and a quantitative general equilibrium model, which are then described in detail. Market size and the economies of scale are presented in figures, for example, competitiveness and breakeven point curves, and illustrations of welfare impacts.[6]

Chapter two is about *common trade policy.* It discusses questions such as why a common trade policy is necessary, the typical figures of international trade with respect to the European Union, the principles, goals and means of common commercial policy, the types of trade relationships, how the part played by free trade agreements gained momentum, or what the connection between disintegration and the trade looks like.[7]

The chapter largely focuses on the means of the common trade policy. They are presented in a figure and then described in detail. The author also goes into detail when he writes about the free trade agreements presenting them individually, country by country.[8] There is an in-depth analysis of Brexit too.[9]

Chapter three, a shorter part of the book, is about *competition policy.* It includes the goals of establishing a common competition policy, state subsidies, the regulations related to undertakings and EU competition rules related to the state.[10] It should be noted that the chapter also includes restrictive agreements, the prohibition of (restrictive) practices, the prohibition on abuse of dominant position, and the control of concentrations between undertakings.[11]

Chapter four is about the *common budget of the European Union*. The author describes the primary features of the EU budget, its principles, changes, the connection of the common budget and European citizens, the structure of the budget, the system of multi-year financial plans, the characteristic features of Hungary *vis a vis* the common budget and the future of the common budget.[12]

Special attention is given to the explanation of the principles of the common budget, for instance, the author goes into detail to describe the principle of externality, the principle of indivisibility, the principle of cohesion, the principle of

6 Halmai, 2020a:31–46.

7 Halmai, 2020a:49–76.

8 Halmai, 2020a:49–76.

9 The author analysed Brexit issues in several studies. Cf. Halmai (2018b; 2020b; 2020c; 2020e).

10 Halmai, 2020a:79–88.

11 Halmai, 2020a:79–88.

12 Halmai, 2020a:91–115.

subsidiarity and the principle of additionality. He sums up the budget changes in chronological order beginning from the 1960s up to the 2010s.[13]

Chapter five is about *common agricultural policy* (CAP). Péter Halmai presents, among others, the goals of common agricultural policy its areas of regulation, its changes, reforms, contractual bases, common market organisations, direct subsidies, integrated rural development, post-2020 schemes, and the future of the system.[14]

As part of the changes and reforms of common agricultural policy, he describes the main outcomes of the Stresa conference held in 1958, then the factors affecting CAP reforms and, finally, the principles of the system after 2013. Following the description of the first and second pillars, he focuses on the period following 2020. He describes the priorities and presents the post-2020 structure of direct subsidies through figures. At the end of the chapter, he discusses the prospects of the future of common agricultural policy and the possibility of a radical reform, including the theoretical option of re-nationalisation.[15]

Chapter six is about *regional policy*. It discusses regional differences of development, presents the concepts of convergence, divergence[16], integration, and specialisation, explains the theory of the location of economic activity, and describes cohesion policy as it operated in Hungary from 2014 to 2020.[17] It has been an evergreen topic in Hungary and the reviewer believes it will remain so for a long time to come. It is a special chapter as it presents the characteristic features of regional policy through excellent figures and maps. In addition to the concept definition mentioned above, the author also reviews the spatial effects of European integration and regional unemployment. At the end of the chapter, the Europe 2020 strategy is presented.[18]

Chapter seven, which is, in fact, the longest part of the book, provides insight into the mysteries of the *Economic and Monetary Union* (EMU). It starts with the establishment of the Economic and Monetary Union, then it identifies the concepts and prerequisites of optimum currency areas. Next, it describes the fundamental features of the Maastricht system, the construction, operation, and experiences of the eurozone, and finally quantitative easing.[19]

13 Halmai, 2020a:91-115.

14 Halmai, 2020a:117-142. Latest comprehensive discussion of the subject, cf: Halmai (2020h).

15 Halmai, 2020a:17-142.

16 On the convergence problem cf. p.ex.: Halmai–Vásáry (2010a; 2012), Halmai (2009; 2019a; 2019b; 2021b).

17 Halmai, 2020a:145-176.

18 Halmai, 2020a:145-176.

19 Halmai, 2020a:177-215.

The establishment of the Economic and Monetary Union is set against a historical background, beginning with the Hague summit in 1969 to the intergovernmental conference of the European Council organised in Strasbourg in December 1989. Of the theories of optimum currency zones, the author analyses the „impossible trinity," real exchange rate and purchasing power parity. Particular emphasis is given to the presentation of the euro system, introducing the main characteristics of the European Central Bank (ECB) and the national banks of the eurozone. Later, the Taylor rules and single monetary policy is introduced. In the last part of the chapter, the author discusses the initial experience and pitfalls of the introduction of the euro, for example, the oil-shock at the beginning of the 2000s or the period following the 9/11 terrorist attacks.[20]

Chapter eight is about *economic policy coordination*, *fiscal policy*, and the *stability pact*. Sub-chapters include comprehensive economic guidelines, fiscal policy in the eurozone, the Stability, Coordination and Growth Pact, the inconsistencies of the Stability Pact, and procedures aimed to manage macroeconomic imbalances.[21]

With the help of the chapter, readers can get an in-depth analysis of the following questions: What is to be given up when a state joins the European Monetary Union? What is the meaning of discretional fiscal policy? What problems can arise as a result of the lack of fiscal discipline in the eurozone and the goals set in the Euro Plus Pact signed in 2011? What is the central component of the procedure to manage macroeconomic imbalances.[22]

Chapter nine deals with the *system and future of the Economic and Monetary Union* (EMU). It is an in-depth analysis revealing the structural issues of the EMU, while it defines a multi-speed Europe, and discusses how the last financial and economic crisis was managed, as well as EMU reforms.[23]

Chapter nine, in fact, is a continuation of the ideas of chapter seven, for instance, by presenting the factors leading to the *introduction of the euro* and the dimensions of *convergence*. In the sub-chapters, the author provides detailed definitions of the following terms: monetary (currency) union, fiscal sovereignty and discipline, banking supervision in the Member States, limited economic policy coordination and the assumption of the endogeneity of an optimum currency area. Next, one can read about the imbalances of the current account and the set

20 Halmai, 2020a:op.cit.177–215.

21 Halmai, 2020a:217–234.

22 Halmai, 2020a:217–234.

23 Halmai, 2020a:235–266. The EMU was discussed in detail in the following studies: Halmai (2013; 2017; 2018c; 2019c; 2020a; d; e; 2021a; c; 2022).

of tools available to the Economic and Monetary Union today, as well as the possibility of its prospective reform.[24]

Chapter ten is about the *erosion of the European growth potential*. It discusses the trends of productivity, ageing societies, the downturn of the European growth potential, and the lessons to be learnt from the last financial and economic crisis.[25] At the beginning of the chapter, the factors explaining the dynamics of productivity are presented, for instance, the evolution of the number of hours worked or total factor production. Then, the main reasons of the downturn of the potential growth rate are analysed, including the limited possibility of increasing employment, or the downturn of the dynamics of total factor production. In the last part of the chapter, readers are provided with a description of the circumstances of recovery from the 2008 financial and economic crisis, and the post-crisis situation.[26]

The last chapter deals with *European growth programmes*. Titles of the sub-chapters include the Lisbon strategy, the impact of structural reforms, macroeconomic effects, and the Europe 2020 strategy. The latter was already mentioned in earlier chapters, but here it is discussed in greater detail. Thus, it includes the goals and priorities recorded in the strategy, an economy based on innovation and inclusive growth.[27]

The chapters of the book offer multiple insight into the theoretical bases of economic integration, the common trade policy, the competition policy, the budget of the European Union, the common agricultural policy, the common regional policy, the Economic and Monetary Union, the economic policy coordination, the future of the Economic and Monetary Union, the erosion of the European growth potential, and the European Union's agenda for growth. In the book, examples are given to present the different historical periods of economic integration focusing on the process as economic integration gained momentum. Excellent figures, tables, maps, and charts help readers in an in-depth understanding of the various chapters. The book is certainly recommended for professionals and researchers interested in the processes of European economic integration. In addition, with respect to its style, depth, and content, it will be indispensable and mandatory literature for undergraduate and postgraduate students of European

24 Halmai, 2020a:235–266.

25 Halmai, 2020a:269–283. On the background of the development theory and the growth impact of integration, cf. Elekes – Halmai (2013a; b; 2019); Halmai (2011; 2014; 2015a; b; 2018a); Halmai–Vásáry (2010b; 2011).

26 Halmai, 2020a:269–283.

27 Halmai, 2020a:285–303. The ideas discussed in the book can be used well for analysing new EU growth programmes.

integration. The reviewer is sure this book will enrich the list of textbooks on European integration, which tends to be quite narrow these days. The chapters discuss issues of basic importance in accessible language but with professional accuracy. The book should not be missing from the collections of high-standard researchers or the shelves of libraries and universities.

Szabolcs Pásztor – Szintia Tamás

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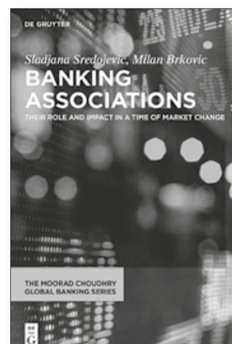
BANKING ASSOCIATIONS IN A TIME OF CHANGE



Sladjana Sredojevic – Milan Brkovic
Banking Associations
Their Role and Impact
***in a Time of Market Chang*e**

The Moorad Choudhry
Global Banking Series
Berlin/Boston, 2022
Walter de Gruyter GmbH

When issues of economic policy and the economy in general are discussed, the banking sector as an area affecting the performance of all other industries is paid specific emphatic attention. This is logical since it is the only industry reflecting economic changes, i.e., when the economy is booming, the banking sector is happy and vice versa. If you look at its impact mechanism, though, you will see its primary position. If the banking sector can play an active part in economic growth or – these days - in sustainable growth, economic development will be more dynamic, foreign trade relations will be more direct and the country will be able to attract more capital.

The banking associations of different countries effectively coordinate the economic involvement of the banking sector, its development, its regulatory environment, government relations and interest representation (Statutes, 2022). That is why the book *"Banking Associations – Their Role and Impact in a Time of Market Change"* published this year offers exciting reading.

The book was written by Sladjana Sredojevic and Milan Brkovic of the Association of Serbian Banks. It was published by Walter de Gruyter Gmbh Berlin/Boston, it contains 249 pages and is available both electronically or in hard copy.

The authors provided a thorough history of the world's bank associations, 70 altogether, covering their governance structure, main goals and specific activities. All bank associations in Europe, the leading bank associations in other global regions as well as the international banking federations consisting of the banking associations of different continents have been discussed.

The book is divided into three main parts (i) the history, structure, shareholders, overall goals and tasks of banking assocations, (ii) the shareholders of banking assocations, the evolution of their activities and priorities, their economic impact,

(iii) the introduction of each banking association and a summary of the part they play beyond their usual activities.

As a subjective author of this Review, let me now underline the dates when the banking associations were founded. The first banking associations appeared in the second half of the 19th century including the American Bankers Association, which was founded in Saratoga Springs (N.Y.) in 1875, and the Canadian Bankers Association set up in Montreal, which was the economic centre at the time, in 1891. In Europe the foundation of banking associations started at the beginning of the 20th century, such as in Germany in 1901, in Hungary in 1903 and in Switzerland in 1912 (one should not forget, it was before World War I).

In Hungary the National Association of Financial Institutions (POE) was the first banking association-type interest representation body, which was followed by many others. The Association of Savings Banks and Banks (TÉBE) founded in 1919 was outstanding among them. "Those two (i.e.: POE and TÉBE) were the most important interest representation bodies of the banking community in the first half of the 20th century" (*Müller*, 2014, p. 10.).

Wolrd War I was followed by another wave of setting up banking associations partly in the new countries emerging as the Austro-Hungarian Monarchy disintegrated (for instance in Yugoslavia in 1921), and in some other countries that had been lagging behind such as in Italy in 1919 or in Greece in 1928. The next wave followed the 1929-1933 Great Depression (for instance, Egypt in 1936 or Luxembourg in 1939). And the next big wave came about in Central Europe after the fall of communism, when new banking associations were set up to replace those terminated in the post-WW II years, for instance in Hungary in 1989 – the first in this region.

Another outstanding area worth special attention is related to the questionnaires designed by the authors. One of the interesting questions is whether national banking associations and their activities are sufficiently known in their respective societies. Two-third of the banking associations answered NO to the question.

The other exciting question looks into the future. What will be the main tasks of banking associations in future? Two-third of the respondents voted for stronger interest representation of their members while 50% supported stronger media presence and one-third emphasised activities focusing more on the clientéle of the banks.

Sladjana Sredojevic and Milan Brkovic produced their book '*Banking Associations: Roles and Impact in a Time of Change*' to commemorate the 100-year anniversary of the foundation of the Serbian Banking Association. In it, they discussed at length the history, functions of the banking assocations and their tasks as they changed in time. The book is a gap filler, since individual national banking

associations only presented their histories previously. No global summary or a comparison of their development and activities had been produced earlier. Making use of the reasonable limits of size, the authors have risen to the challenge. The book may also be of public interest, as it fits the activities of different national banking associations neatly into the global financial system. All actors of our industry will find it illuminating and it can be recommended to everybody who is interested in important social and economic issues. And with a view to closer and wider Serbian-Hungarian connections, I am happy to popularise this book.

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