

The Pénzintézeti Központ was established 100 years ago*

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On the occasion of the centenary of the Pénzintézeti Központ's establishment in 1916 as the first integrated supervisory "top-level organisation", this study endeavours to outline the historical background and the stages of the formation of the institution, starting in the second half of the 19th century. The analysis seeks to determine the factors that led to the emergence of the activities and operating framework of the Pénzintézeti Központ, the supervisory paradigms that influenced its inception and the negative experiences or circumstances that can be associated with its activities. The study presents the operation of the supervisory bodies preceding the Pénzintézeti Központ as regards banks, savings banks and cooperatives, and aims to show the contemporary economic conditions and the situation of the financial architecture, in line with contemporary thinking and on the basis of the relevant opinions of the experts from that era.

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1. Introduction

Many steps led to the founding of the Pénzintézeti Központ as the supervisory "top-level organisation", and various supervisory paradigms were employed during its development. Among the paradigms in the history of Hungarian supervision, the so-called "Anglo-Saxon" type stands out. In line with the manifestation of the approach of "methodological individualism", it regarded informal supervision based on consultations, the "conscience" of the supervised institution and the institution's own individual inspections as its necessary objective, assuming ideal-typical actors (*Vittas 1992:21*). The main premise of the "Anglo-Saxon" method was that stable operations are in the financial institution's own interest. Characteristic of this approach was voluntary inspection, which meant that the financial institution

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assessed its legal compliance and ability to maintain long-term, profitable operations using its internal staff (the internal audit team and the supervisory board). The “Anglo-Saxon” supervisory system was based on the belief that only the accuracy and the veracity of the balance sheet should be assessed, and the inspection should not include management consulting, the evaluation of corporate governance, the assessment of credit risks, or whether the institution was “*managed wisely or unwisely, profitably or not profitably*” (Éber 1911:801).

The so-called “classical” (or continental) train of thought was also present in the history of Hungarian supervision. It was characterised by a preference for an approach based on intensive on-site inspections, as well as detailed, meticulous regulations covering as many areas as possible. A change of paradigm is perceptible in the history of Hungarian supervision, and this can be observed in the operation of the supervisory bodies preceding the Pénzintézetési Központ. At the turn of the century, several organisations were formed that also had supervisory powers, which demonstrates that organising supervision (preferably in an institutionalised form) was considered necessary at that time. This attitude was strengthened by failing financial institution actors, the very large number of financial institutions and their increasing concentration: in 1911 in Hungary, almost twice as many banks functioned in Budapest alone than all the financial institutions in Austria combined, and in this period the Hungarian banking sector, especially the five biggest banks in Budapest, considerably increased their influence over the economy through financial capital.

In the second half of the 19th century – and especially towards its end – these paradigms were combined and the models were “fine-tuned” (i.e. certain factors were partially changed). The “modern”, risk-based approach that compares individual material risks to the regulatory capital as an adjusted capital value had not yet emerged in that era. The presence of various supervisory paradigms should not lead one to conclude that they were unsuccessful, just as the alteration of the individual streams of economic philosophy over time does not suggest their inappropriate approach to the external and internal economic environments. It merely shows the constant flux of economic conditions, circumstances and processes, and thus the need for modifying response capacities.

In the following sections, the implementation of the individual supervisory paradigms in the various organisations will be demonstrated, as well as the professional debates surrounding the relevant paradigms, with a special focus on the structure of the Pénzintézetési Központ and the uneven road that led to its formation.

2. The operation of supervisory bodies before the establishment of the Pénztézet Központ

On the initiative of István Tisza, who later became prime minister, the Magyar Takarékpénztárak Központi Jelzálogbankja (Central Mortgage Bank of the Hungarian Savings Banks) was set up. Its primary goal was to convert the capital in mortgage loans into marketable securities, thereby enabling the assignment of receivables arising from mortgage loans to the Jelzálogbank as the institution authorised to issue debentures, thus facilitating the access of provincial smallholders to loans (Kovács 2004:134; Domány 1926:439). The Jelzálogbank liaised only with savings banks that agreed to the Jelzálogbank reviewing its entire business administration and balance sheet annually (Botos 2002:39). This review function of the Jelzálogbank was therefore a sort of precursor to the future Pénztézet Központ's similar function. The review function of the Jelzálogbank was a cross between the "Anglo-Saxon" and the "classical" models, as it did not regard the approach of the "Anglo-Saxon" model primarily based on self-assessment as adequate; however, it did not include the detailed inspection seen in the "classical" model either.

The Országos Központi Hitelszövetkezet (National Central Credit Union) was established some years later in 1898, and it was considered the centre of the Hungarian cooperative movement as well as the "dedicated resource of Hungarian cooperative life" (Schandl 1938:3). In addition to its most important tasks stipulated by law – i.e. satisfying the loan demand of credit unions, and the spread and promotion of the cooperative idea – it also exercised inspection and regulatory powers with respect to the business management of the cooperatives "within its ranks".¹ The law also stipulated that should the Hitelszövetkezet detect any measures in the activities of a supervisory board of a cooperative "within its ranks" which were against the law or statutes, or any negligence or fraud jeopardising the interests of the cooperative, the Hitelszövetkezet should call a general meeting immediately. In such cases, it could also suspend the board of directors or its individual members until the general meeting was held, and it could take measures for temporary business management. In this respect, the Hitelszövetkezet diverged from the "Anglo-Saxon" approach, and it represented a more assertive use of supervisory powers and a higher level of supervisory interference. It was also tasked with (partially) taking over the client base of institutions under liquidation, with transforming smaller, unviable "microbanks", which operated inefficiently from the perspective of economies of scale, and with granting loans to smallholders and

¹ Based on Article 57 of Act XXIII of 1898 on Economic and Industrial Credit Unions.

tradesmen with favourable conditions² (*Adler 1915:170*). The Hitelszövetkezet's functioning was important not only from a supervisory perspective, but also from an economic one: the credit supply to provincial farmers was prone to constant interruptions because savings banks largely restricted their activities to larger villages and county seats, and "*their loans were either excessive or insufficient, but always ruinously³ expensive*" (*Blum 1899:750*). The loans extended by financial institutions (and land loan institutions) covering larger areas were only available to wealthier farmers (*Schandl 1938:27*). By contrast, even in the early years of its operation, the Hitelszövetkezet, with its extensive network of member cooperatives, granted provincial farmers access to short and medium-term annuity loans aligned with their activities.

The Magyarországi Pénzintézetek Országos Szövetsége (National Association of Hungarian Financial Institutions, MPOSZ), established in 1903, can be considered the first step towards institutionalised banking supervision in Hungary. Although the MPOSZ mainly functioned as the representative body of financial institutions (*Botos 1994:11*), it is also worth mentioning in relation to the later institutionalised supervision, since its tasks included the provision of "*professional guidance with regard to determining the correct business principles related to depositing the assets of provincial financial institutions*" and "*the financial and moral support of provincial financial institutions in crisis*" (*Jakabb et al. 1941:31*). The economic proactivity of MPOSZ is also demonstrated by how early it recognised the importance of provincial financial institutions, yet several aspects of its operations prevented it from exercising adequate supervision of financial institutions. One of the reasons for this was that its scope of activities was very broad; in addition to its supervisory tasks, it also had other duties (e.g. providing professional guidance on depositing the assets of the member institutions, the establishment of a national loan information system). The extensive nature of its activities is also illustrated by the fact that it took part in developing the by-laws of the institutions, which also showed a proactive supervisory character. On the other hand, larger banking groups did not join the MPOSZ (*Botos 1994:17*), and its operation – centred around "self-governance" – enabled financial institutions to request reviews relatively rarely (*Hantos 1916:24*) based on their voluntary decisions. This also contributed to the inefficient functioning of the MPOSZ as a supervisory body. Due to the relative weakness of the supervisory powers and the MPOSZ's role of being the primary representative body of financial institutions, the "Anglo-Saxon" method gained prominence in the organisation's activities.

² The powers and inspection capacities of the Országos Központi Hitelszövetkezet were further bolstered by the fact that from 1920, pursuant to Article 2 of Act XXX of 1920 on Amending and Supplementing Act XXIII of 1898 on Economic and Industrial Credit Unions, credit unions could only be established on the condition that they joined the Hitelszövetkezet.

³ "Devastatingly", "damagingly".

The efficiency of the MPOSZ's measures was undermined by the Pénzüntézetek Országos Egyesülete⁴ (National Association of Financial Institutions, POE), which was established on the initiative of Undersecretary of State Elemér Hantos – who also headed the institution until November 1917 – and which basically acted as the MPOSZ's "rival" during that period. The conflicts arising between these two associations were detrimental to the continuous conduct of business for both. Although a so-called revision committee was formed within the framework of the MPOSZ, it performed no substantial, significant tasks (Éber 1912a:55). These factors determined the actual weight and scope of authority of the MPOSZ, as well as its influence on the financial processes and legislation, resulting in relatively modest success in promoting the institution's interests. Nevertheless, some basic principles emerged during the operation of the MPOSZ, and a number of practices were implemented during the inspections that can also be observed in today's supervisory inspections: for example, the "four-eyes principle", which required at least two inspectors to carry out audits, and the unannounced inspections that the MPOSZ was authorised to perform (Hantos 1916:30). Inspectors employed by the MPOSZ were required to pass a test which proved that they possessed the professional knowledge necessary for performing the inspections. The concept of bank secrecy also emerged in connection with these inspections, because inspectors had to treat the experiences gained during an inspection as strictly confidential, and "whoever failed to do so was guilty of the gravest misconduct, since they breached their oath" (Hantos 1916:34). The statute of the MPOSZ stipulated that the inspectors were obliged to make recommendations in connection with findings in order to correct omissions, taking into account the "interest" of the institution under inspection. The inspection process included reviews of the bookkeeping, business management, inventory and balance sheets of the given institution. The inspectors had to answer predetermined questions with respect to the topics under inspection (e.g. capital position, securities business, current account business, savings deposit business) by filling out a kind of worksheet which formed the basis of the inspection report.

In addition to the MPOSZ, several organisations protecting and enforcing the interests of financial institutions were formed in the first half of the 20th century (e.g. Takarékpénztárak és Bankok Egyesülete [Association of Savings Banks and Banks], Bankárok és Értékpapírkereskedők Országos Egyesülete [National Association of Bankers and Securities Traders]) (Müller et al. 2014:10). These had no supervisory or review functions, yet as they advanced the standardisation of business management, bookkeeping and balance sheet compilation practices, their operation is also worth mentioning from the perspective of supervisory history.

⁴ The scope of functions of the POE was identical to that of the MPOSZ, and it could not fulfil its original function primarily because its member institutions were mainly provincial banks and savings bank. Thus, it lost a large share of its members after the Treaty of Trianon (Botos 1994:19).

3. The background to the Pénzintézet Központ's establishment

3.1. The Trade Act of 1875

The operation of financial institutions had been regulated at different levels even before the Pénzintézet Központ was founded. Many aspects of the activities of financial institutions were regulated by the Trade Act of 1875. The Act also included a precise definition of the concept of financial institutions, because prior to passing the act, there had been “*utter confusion*” (Schandl 1938:35) regarding the legal concepts and activities of banks, mutual benefit funds, savings banks and cooperatives. The importance of the Act is demonstrated by the speech of lawyer, economist, academician and university professor Ödön Kuncz delivered at the meeting of the Hungarian Economic Association on 9 February 1926, in which he stated that “[*the Act*] does not merely regulate the legal relations between trade and traders, but also creates a firm basis of a whole empire of intensive production”. However, Kuncz added in connection with the Act that it had not been “*completely modern even when it was drafted*” (Kuncz 1926:147). Preceding Kuncz’s remarks by approximately 30 years, objections to the Act were voiced in 1899, namely that it was “*liberal*” and that its contents had “*proved to be outdated and imperfect in many respects, and inadequate in general*” (Sugár 1899:404). The most important proposals in connection with reforming the Act were to replace its “*negative attitude and nonchalance with [the notion of] active state involvement*”, to prevent the “*creation and operation of (further) fraudulent, unrealistic companies*” (Kuncz 1926:152), and to protect the operation of companies with actual economic weight. This was necessary because the Act of 1875 made the creation and supervision of financial institutions a mere formality (Jirkovsky 1945:170). In addition to the above, some extreme opinions surfaced, claiming that due to the “*loose*” provisions of the Trade Act, household insurance contributions were being siphoned abroad, primarily through insurance corporations (Róth 1890:4), and that rules regulating the creation and business management of insurance corporations in the Trade Act were inadequate (Poór 1900:459). The court only assessed legal compliance (e.g. the adequacy of decisions at general meetings). The inspection did not cover the veracity of the inventory or whether the stock of securities and bills of exchange were actually available, because these tasks – based on the “*Anglo-Saxon*” paradigm – fell within the purview of the supervisory board.

While many proposals were made for reforming the Trade Act (e.g. in 1894 with respect to the regulation of the cooperatives’ operation), these were not supported by the Chamber of Commerce and Industry (Schandl 1938:23). This was probably due to the fact that there was no consensus about the necessity of reforming the Act, and even in 1896 there were opinions that its core and spirit were good, and that its main principles were sound (Matlekovits 1896:63).

3.2. Reasons and circumstances leading to the establishment of the Pénzügyintézet

Several factors contributed to the formation of the Pénzügyintézet. For the most part, these were not institution-specific but generally applicable to the financial institution sector. The need for the creation of an institutionalised supervisory body was emphasised by the Trade Act of 1875 not being proactive enough, its excessively permissive regulations and the resulting great number of financial institution actors which in some cases lacked even economic justification, negative developments in the maturity matching of assets and liabilities characteristic of financial institutions and in the ratio of share and loan capital, and the increasing number of failing financial institutions (*Teleszky 1927:356; Hantos 1916:8*). In 1869–1887, 32 savings banks went bankrupt, including both smaller institutions (e.g. Cserevenkai, Eszék-Alsóvárosi, Püspökladányi Takarékpénztár [Savings Banks of Crvenka, Donji grad (Osijek), Püspökladány]) and large, established savings banks (e.g. Aradi-, Máramarosszigeti-, Újvidéki Takarékpénztár [Savings Banks of Arad, Sighetu Marmăției, Novi Sad]). Naturally, similar to the recent economic crisis, this resulted in a kind of tension and loss of confidence (*Blum 1899:745*), thereby facilitating institutional and regulatory changes (in both eras). Financial institutions failed in later years, too: for example, the Székelyegyleti Első Takarékpénztár (First Savings Banks of the Székely Association) went bankrupt in 1901 (*Szász 1966:123*). In this context, the remarks by General Superintendent Gábor Daniel – the Lord Lieutenant of Udvarhely county – in the opening speech of the 1903 Synod of Vargyas reflect the dwindling confidence in other financial institutions as well as the knock-on effects: “*The failure of the Székelyegyleti Első Takarékpénztár affected our church dramatically, especially our Székelykeresztúr district, which led me to make a proposal to the Council of Representatives in our Church for the partial withdrawal of our – at that time – considerable deposits from the financial institutions of Cluj-Napoca.*” He then later added: “*Besides, I believe that you still agree with me that it is best to invest our capital in land and in safe government securities.*” (*Daniel 1903:251*) After the bankruptcy of the Székelyegyleti Első Takarékpénztár, the representatives of Udvarhely county demanded the state regulation of financial institutions. Kálmán Széll, the prime minister at that time, argued for the need of regulating financial institutions in his speech in Parliament on 19 November 1902 (*Szász 1966:136*). Nevertheless, there were some who believed that there had been no substantially corrupt practices and failures, and that Hungary was faring relatively well at the time of the New York stock exchange crash of 1907 (*Éber 1912a:64; Domány 1926:433*).

The failures of the financial institutions were due to various reasons. First, the international paucity of money caused by the news of the eruption of the Second Boer War (1899–1902) and the resulting spillover effects that also affected Hungary, the flow of debentures deposited abroad back to Hungary, and the general outflow

of foreign capital as a result of the economic paralysis of industrial and trading companies exerted a significant effect on the Hungarian financial institution sector, too. The savings banks operating in Arad, Sighetu Marmației and Nové Zámky were close to insolvency. The Aradi (later Első Aradi) Takarékpénztár ([First] Savings Bank of Arad), which was established among the first savings banks after the creation of the Pesti Hazai Első Takarékpénztár [First National Savings Bank of Pest] and started operating on 19 March 1840 (*Vargha 1896:102*), deserves special mention. In addition to the change in external circumstances, in many cases the failure of the savings banks could be attributed to internal operational reasons, particularly misappropriation. For years, the Érsekújvári Takarékpénztár [Savings Bank of Nové Zámky], falsely reporting its profits, paid out its entire share and reserve capital and part of the deposits in dividends (*Blum 1899:762*). The Soproni Építő és Földhitelbank [Construction and Land Loan Bank of Sopron] was established in 1872 and it failed in 1901. Although it had already lost its share capital in 1883 as a result of stock exchange speculations, it operated for another 11 years, reporting considerable profits and paying out correspondingly high dividends. In some cases, financial institutions entered into transactions, having only 10% of the necessary collateral (*Horváth 1995:3*). Third, in addition to the economic recession and the lack of effective regulation, Article 5 of Act IX of 1848 on the Abolition of Seigniorial Obligations⁵ imposed a moratorium on the repayment of a substantial share of mortgage loans, which also contributed to the failure of financial institutions. This severely affected the situation of the savings banks, some of which attempted to sell their stock of securities at a lower price – caused by increased supply – and some of which (including the Pesti Hazai Első Takarékpénztár) applied for emergency aid. New loans could only be extended on the basis of stricter assessment criteria, and some savings banks were temporarily banned from that as well (*Vargha 1896:133*). In addition to misappropriation and speculation, corrupt practices were also rife. One must mention the Újvidéki Takarékpénztár, where several forged bills of exchange were deposited, causing a deficit of 150,000 koronas.⁶

In addition to the domestic, internal need and the increasing prominence of interests long present and strengthening, the establishment of the Pénzintézeti Központ and the development of its supervisory activities with respect to banks were also motivated by the fact that in the early 20th century, bank capital was considerably entwined with industrial capital (creating so-called finance capital) (*Tomka 1999:48*). As a result, less well-capitalised financial institutions, especially provincial institutions, lost ground to financial institutions in Budapest which were

⁵ “With the exception of bills of exchange from trade transactions, no debt claims against landowners whose estate was linked to socage before this Act entered into force may be withdrawn pending further legal provisions, and only claims for the payment of legally guaranteed interest may be enforced in court” (Based on Article 5 of Act IX of 1848 on the Abolition of Services (Corvée), Tithe and Cash Payments Provided Until the Present Based On Socage and Supplementary Contracts).

⁶ Based on Page 5, Volume 2, Issue 51 of Magyar Paizs (19 December 1901).

predominantly well-capitalised (*Szádeczky-Kardoss 1928:114*). On account of the concentration, various interests (e.g. those of industrial companies) also surfaced, which may have contributed to the increased calls for regulation in the sector. The intertwined nature of the banks and industrial capital can be seen in the fact that the largest industrial, mining, commercial and transport companies belonged to the sphere of interest of a few large domestic banks. In 1913,⁷ 225 large industrial limited companies were influenced by the five largest banks of Budapest, with a total share capital of almost 711 million koronas, representing 51% of the capital of all mining and industrial companies operating in the form of limited companies. Thus, the Hungarian banking sector further increased its influence and control of the domestic economy before the First World War. As a result, the scope of activities of this “new” type of bank became more complex; in addition to supplying credit, financing companies, and issuing and depositing shares and bonds, their activities now included the creation of new companies, active involvement in the development and management of existing companies, resolution of bankrupt companies, and organisation of the production and sales in whole industries (*Tomka 1999:47; Botos 1994:25*). On account of the stronger economic spillover effects, the “transformed” big banks boosted the willingness to organise financial regulation.

There was a close correlation between the merging of bank capital and industry and the concentration of financial institutions (which also motivated the organisation of regulation), since the demand for loans by industrial companies – due to their volume – could only be satisfied by well-capitalised financial institutions (*Ács 1936:318*). Several other factors contributed to the increasing concentration of financial institutions in the early 20th century in Hungary. These were economic on the one hand (e.g. brighter lending prospects, greater confidence in the security of clients’ deposits, better possibilities for expansion, higher business “prestige”) and psychological on the other (e.g. increased entrepreneurial spirit with respect to managing complex companies posing more substantial challenges and risks). The third reason for the increased concentration of financial institutions lay in capital, which constantly motivated companies to expand and to invest it again and again. The intention of making borrowing more attractive also fostered banking concentration, because the public believed that the relatively expensive loans in certain periods were caused by the considerable operating and maintenance costs of the oversized lending structure. According to this view, the insufficient amount of available loans, which was also typical because of their relative expensiveness, continued to be a social problem and hindered progress (*Domány 1926:432–457*).

The need to set up regulation within an institutional framework was also heightened by the increasing number of credit institutions, which jumped from 1,598 to 5,033

⁷ In the same year, 121 financial institutions operated in Budapest (excluding cooperative-type institutions (*Szádeczky-Kardoss, 1928:69*)).

between 1894 and 1913 (Tomka 2000:62). The proliferation of credit institutions⁸ was also condemned by the chief secretary of the Austro-Hungarian Bank, József Pranger. In a speech in 1912, he “vehemently demanded that the mushrooming of credit institutions be halted” (Domány 1926:434). In the same year, Lipót Horváth, an influential banker, deemed economic measures suitable only with respect to complicating the situation of new credit institutions and decreasing their number. He proposed that the Austro-Hungarian Bank should deny rediscounting with respect to these institutions (Éber 1912a:62). Hantos (1916:62) also spoke out against the large number of credit institutions in his speech at the House of Representatives on 6 May 1914, in which he emphasised that Hungary had more credit institutions than Austria and Germany combined. The perception of these newly established credit institutions was further undermined by the fact that in several cases, the share capital necessary for the formation of the institution was only paid by owners and founders when the capital position of the credit institution urgently necessitated it (i.e. when the institution was close to insolvency). In many cases when the share capital was increased, it turned out that not even the original share capital was available, because it had not been paid. Due to these reasons, according to the proposal of Miksa Havas, an academic professor and the inspector of the Chamber, it was important to begin inspections of the newly established financial institutions (Éber 1912a:56).

In 1915, the two most important steps in rebuilding Hungary after the world war⁹ were considered to be the development of state supervision and the emancipation of minorities (Adler 1915:171). This was justified, as the events of the world war had developed favourably for the Austro-Hungarian Empire until that point: the Gorlice breakthrough and the stabilisation of the front at Doberdò were indisputable military successes. The process of the review of financial institutions’ operations and the conditions for performing inspections had to be developed during the war, as afterwards, when a great volume of savings was expected to be deposited, the financial intermediary system had to already be regulated and the financial preparedness of financial institutions had to be ensured.¹⁰ In 1915, Hantos (1915:33) underlined the importance of organising the transition from a war economy to normal production as soon as possible, reflecting the confidence in the future. He

⁸ In 1911, approximately 200 new financial institutions were formed. By comparison it is worth mentioning that while in the same year a total of 67 financial institutions operated in Austria, the number of banks in Budapest alone was 121 (Éber 1911:797).

⁹ On the basis of the initial military successes in the war, the confidence in a future victory and the hope for indemnity and reparations, the development of a stable, regulated financial intermediary system was to be promoted.

¹⁰ “The substantial funding needs of the state after the war and the predictably substantially increased credit requirement of the public will impose huge tasks on financial institutions [...] and in order to avoid a shock to our economy, we have to assist financial institutions by all means in adequately performing their challenging duties, because that is the only way the necessary revival of our economic life after the war can be guided onto a healthy path.” (Jakobb et al. 1941:35)

considered the development of financial supervision just as important as organising the army (Hantos 1916:69); therefore, we can agree with the economist and historian György Ürögdi (1948:207) that popular sentiment demanded the state supervision of financial institutions.

The emergence of the preventive approach should be emphasised, as a result of which, in addition to repressive legal acts and rules, fundamentally forward-looking and preventive measures also received prominence: “... *no flagrant cases can serve as the basis for violent, inconsiderate interventions [...], we need preventive rather than repressive rules. We should not eradicate the whole garden, only the weeds*” (Sugár 1899:407). Pál Berényi (1904:396), a teacher of the Academy of Trade in Sopron, also promoted this approach in a review published in 1904, in which he declared that taking preventive measures was absolutely necessary in order to ensure that there were no circumstances in the operations of financial institutions that would suggest corrupt practices or negligence.

As a result of the regulatory discrepancies regarding financial institutions, it was characteristic of the operations of financial institutions in Hungary that the business practices of savings banks and commercial banks were often not clearly separated (Sugár 1899:405; Domány 1926:435), and thus there were cases where savings banks provided funds to industrial companies from savings deposits (Teleszky 1927:356). By way of example, one could mention the Pozsonyi Takarékpénztár [Savings Bank of Bratislava], which played a significant role in providing funding to two industrial companies early after it was established. It also granted loans to the Malomvölgy-társulat [Mill Valley Society] operating in the vicinity of Bratislava, and it contributed actively to the construction of the railway line between Bratislava and Trnava. The deficiencies in defining the concept of financial institutions are demonstrated by the following remark: “*the notion or nature of a financial institution [...] remains obscure. Does a financial institution suggest a limited company, a cooperative, a general partnership or a simple natural person? We do not know*” (Hantos 1916:23). As a result, the public could not be expected to distinguish between financial institutions: “*we see that the people do not differentiate between a savings bank, a bank and a credit institution, and they take their money with full confidence to the nearest institution*” (Blum 1899:758). And “*banks encroach on the savings deposit business line, just as savings banks do on bank-like business. The categorisation that distinguished between land loan institutions, banks and savings banks is just a remnant of the past...*” (Hantos 1930:677). Distinguishing between the different institutions was made more difficult by the fact that in the 1890s, so-called “fake cooperatives” started to spread (e.g. the so-called “korona cooperatives”). These were only “cooperatives” in name: their activities did not show any kind of cooperative character, and they were basically dominated by usury. The operations of these institutions, however, were considerably hampered by the

establishment of the Országos Központi Hitelszövetkezet in 1898 and the spread of cooperatives (Schandl 1938:38–76). Also, the “*eradication of usury’s plague*” was achieved temporarily (Sugár 1899:407).

3.3. Professional debates related to the establishment of the Pénzintézetési Központ

Several debates were held among professionals in connection with the formation of the Pénzintézetési Központ on various platforms, and contrasting views developed among economic thinkers. For example, in the case of savings banks, there were proposals promoting strict, material supervision in line with the “classical” model. These plans aimed to “*restrict the operating activities of savings banks through legislative measures so that their operation should be constrained to making profits from their deposits and their share capital, with a complete ban on rediscounting. Furthermore, we should require our savings banks to only invest their funds into government securities, debentures and mortgages*” (Székely 1890:310). This direct type of central regulation (which was proposed to be introduced on the basis of the contemporary German and Austrian model) was rejected by the future justice minister Ferenc Székely (1890:311), who stated that whatever was “*flawed in our country, we should fix taking into account our special circumstances and the financial and general economic conditions of the country. We should learn from foreign nations but we should not slavishly imitate them.*” Brúnó Blum, a senior officer at the Budapesti Bankegyesület [Bank Association of Budapest] also emphasised the importance of independently developing regulation in Hungary: “*we cannot [...] simply copy whatever worked abroad. By taking into account the actual situation and our special domestic circumstances, we should create a new system, Hungarian to the core*” (1899:763). Ignác Sugár, who was the secretary of the Chamber of Commerce and Industry of Miskolc at that time, propagated a less direct, more lenient type of regulation. He stated that substantially interfering in financial institutions’ practices for handling deposits, bill discounting and rediscounting, as well as their mortgage loan business line, was a “*mistake in theory, and impossible in practice*”, and he believed that in this respect “*no [...] central organisation, chamber of financial institutions or other similar institution would help*” (1899:414). In contrast, he focused on controlling corporate governance and business management, and the importance of educating skilled professionals.

When the draft proposal for establishing the Pénzintézetési Központ was made public in March 1915, financial institutions voiced their concern that it would develop into a large state bank, restricting competition. Another debate was sparked about the inspections with respect to the scope of institutions they should cover. The majority backed a proposal according to which only smaller financial institutions that obtained loans from the Pénzintézetési Központ should be inspected, unless an inspection was otherwise requested. This proposal was also supported by the fact

the Pénzintézeti Központ, especially in its early period, did not have a sufficient number of inspectors able to perform inspections at every member institution, and carrying out previously undefined inspections based on certain criteria would increase distrust. When the proposal was introduced to parliament, the opposition was against it. They saw concealed political goals and the extension of the government's power in the institution of the Pénzintézeti Központ, and exclusively party-political purposes in the creation of the loss reserve fund (e.g. repayment of debts). Nor was their opinion changed by the statute of the Pénzintézeti Központ, Article 58 of which detailed the purposes of the loss reserve fund. Accordingly, the opposition only approved the establishment of the Pénzintézeti Központ on the condition that its statute be incorporated into law and that the use of the loss reserve fund be controllable by the opposition.

The polemics also included the depth of supervision: Sándor Matlekovits, a lawyer and university professor, and later a member of the Board of the Hungarian Academy of Sciences, regarded the review of specific credit transactions, and in fact any other review that went beyond the assessment of the accuracy of the balance sheet, to be harmful and dangerous from a business perspective (*Éber 1912b:216*). The necessity of supervision was also questioned by, among others, Count Gyula Andrássy II, who had been minister of the interior and then later became foreign minister for a short period. He argued against the Pénzintézeti Központ based on the purpose of its creation, as well as the novelty and reforming nature of its operation; according to him, no reform was necessary that had not become rooted in other countries. Count Albert Apponyi, a minister and member of the Hungarian Academy of Sciences, employing considerable exaggerations without acknowledging the purpose of the Pénzintézeti Központ's formation, stated that the establishment of the Pénzintézeti Központ was tantamount to the elimination of the possibility of political independence and free political opinion (*Jakabb et al. 1941:33–40*). The debate surrounding the necessity of supervision was not only observable in Hungary, but also at the international level. In connection with the 1908/1909 “*Bankenenquete*” containing the proposal for adopting state supervision, *Jakob Riesser (1853–1932)*, an influential contemporary German politician, agreed with the “Anglo-Saxon” paradigm and regarded the operation of state supervisory bodies as harmful because those – according to Riesser – inspired unreasonable confidence among depositors, and they were not suitable for producing reliable findings (*Jakabb et al. 1941:29*). While assessing the domestic and foreign “reform movements” in support of developing financial supervision, *Hantos (1916:55)* came to a similar conclusion: “*The first result we can deduce from the foreign and domestic reform movements is negative in nature, and its essence is that state supervision has neither purpose nor justification.*”

4. Operation of the Pénzintézeti Központ

On 1 June 1916, in the shadow of the First World War, only days before the Brusilov Offensive was launched on the eastern front against the Central Powers, the Pénzintézeti Központ was established with the support of Prime Minister István Tisza and Finance Minister János Teleszky, the chairman of the contemporary “altruistic bank” (*Botos 2002:30*), the Magyar Földhitelintézetek Országos Szövetsége [National Association of Hungarian Land Loan Institutions], and several other financial institutions. Taking into account the circumstances of the age, the following excerpt may sound somewhat out of place, but it does reflect the confidence in the future and the public sentiment in the year of the Pénzintézeti Központ’s creation. It was published for the 75th anniversary of the first Hungarian bank, the Pesti Magyar Kereskedelmi Bank [Hungarian Commercial Bank of Pest], which was also celebrated in 1916. *“We look into the future with a renewed ambition and confidence, knowing that we can fulfil our role in domestic economic life”* (based on *Lamotte 1941:55*).

The statutory purpose of the Pénzintézeti Központ was to function *“in a cooperative form to foster and promote the interests of the economy through those of the financial institutions operating in the Lands of the Holy Hungarian Crown”* initially for a fixed period (five years). The same law authorised the finance minister to *“contribute to the capital of the Pénzintézeti Központ, from the state budget, by taking over shares with a combined nominal value of a 100 million koronas”*.¹¹ The institutions that were eligible to become members of the Pénzintézeti Központ included financial institutions operating in the form of a limited company, savings banks in smaller municipalities and cities (with the permission of the finance minister), the Hungarian branches of foreign financial institutions (which primarily concerned Austrian-owned institutions), cooperatives performing banking activities, financial institutions regulated by another law (e.g. the Magyar Földhitelintézetek Országos Szövetsége) and the Magyar Királyi Államkincstár [Hungarian Royal State Treasury] (*Szádeczky-Kardoss, 1928:33*). Act XIV of 1916, which provided for the establishment and basic functions of the Pénzintézeti Központ, was supplemented by the statute of the Pénzintézeti Központ. Together they defined the conditions of the Pénzintézeti Központ’s operations and settled certain economic policy issues that had arisen in the previous period (e.g. they delineated tasks in connection with the branch in the kingdom of Croatia-Slavonia, which enjoyed autonomy within the Austro-Hungarian Empire, as the regional consultative body of the Pénzintézeti Központ). In response to the earlier “foundation fever” – the period of the Gründerzeit that peaked in 1872 – another significant economic policy step

¹¹ Based on Article 1 of Act XIV of 1916 on the Pénzintézeti Központ.

was the prohibition of the establishment of new financial institutions with a share capital of less than 20 million koronas until 1 January 1919 (*Teleszky 1927:359*).¹²

In order to avoid being influenced by political powers potentially involved in the operation of the Pénzintézeti Központ, the term of the president heading the Pénzintézeti Központ was fixed at five years. The law that we cited stipulated – in line with the earlier proposals – that the Pénzintézeti Központ should only perform restricted inspections; that is, it could only implement audits at member institutions whose share capital was less than 20 million koronas and that requested it, or that had obtained a loan from the Pénzintézeti Központ (*Tomka 2000:81*). At that time, to avoid double supervision, the cooperatives that belonged to the Országos Központi Hitelszövetkezet and were also supervised by it were not audited by the Pénzintézeti Központ. Out of the 1,871 institutions operating in the form of a limited company, 1,261 joined the Pénzintézeti Központ (thereby consenting to a possible inspection). This did not mean higher risk awareness, more judicious functioning or the need for more prudent conduct in and of itself, as unless the institutions obtained funding from the Pénzintézeti Központ or voluntarily requested an inspection, the Pénzintézeti Központ did not provide an opportunity for one. There were also big banks among the 1,261 credit institutions, which is worth mentioning because earlier (in the case of the MPOSZ) this was one of the factors that hampered efficiency: big banks with a greater ability to promote their interests were not part of the organisation. In fact, they only joined the Pénzintézeti Központ after it had guaranteed big banks in its statutes that it did not wish to become their competitor in banking activities (*Botos 1994:23; Jakabb et al. 1941:33*). In contrast to earlier institutions that also possessed supervisory powers (e.g. MPOSZ, POE), the Pénzintézeti Központ did not function as a representative body, which also demonstrated its primary function as a supervisor.

The review activities of the Pénzintézeti Központ could be grouped into four types. The first included the auditing of accounting books (e.g. the implementation of the principle of completeness, the adequate handling of documents), while the second comprised the assessment of internal management (corporate governance) (e.g. the rules of procedure of the board of directors, the specification of mandates and responsibilities and their observance, audit measures (the functioning of an internal control system), bank security rules, the cost/income ratio). The third type included the assessment of conduct, especially the evaluation of lending (i.e. the portfolio), and the review of the composition and volume of share capital and external funds, the regulation of internal loans, and measurement of the amount of the deposit rate paid. The fourth type comprised the review of the balance sheet,

¹² The objection against the introduction of this “objective” condition, however, was justified, since it also made it impossible to establish special financial institutions of critical national economic and strategic importance (e.g. so-called “war banks”) or other financial institutions warranted by an economic rationale that would have been needed – at least by “war banks” – especially in the First World War (*Hantos 1916:71*).

the income statement and the inventory (its analytical evaluation), which included the reconciliation of the balance sheet with the ledger, as well as the assessment of the reserves, the write-downs and the distribution of profit (dividend payment). The areas for supervision listed above were detailed in Annex 1 of the Pénzintézetési Központ's statutes in the form of a review directive. The inspection focused on the areas that posed a high risk, as compared to others in that period (e.g. the booking of rediscounting).

In addition to and complementing its supervisory function, the Pénzintézetési Központ also had resolution powers. The Act on the Pénzintézetési Központ stipulated that in the case of a financial institution's bankruptcy, the Pénzintézetési Központ should play a central role.¹³ In practice this meant that the Pénzintézetési Központ could provide temporary liquidity (from the so-called "mobility reserve") to distressed but sustainable, viable financial institutions. When the Austro-Hungarian Empire was in financial straits and funding by Austrian capital was suspended, the capital shortfall could be felt directly, primarily at smaller financial institutions; therefore there was a great need for an institution providing temporary liquidity (*Teleszky 1927:358*). This core function also contributed to the fact that in the next period the Pénzintézetési Központ (especially as its powers were gradually expanded) became the most important tool for financial supervision or, in a broader sense, state oversight. The duties of the Pénzintézetési Központ in connection with the unsustainable financial institutions are demonstrated by the summary of *László Passuth* in his book about the years he spent as the vice-president of the institution: "*One of the many anecdotes of my uncle was about the time when the bank directors filed out onto the street after the PK was officially established. The all-powerful director of the Kereskedelmi Bank pointed to the façade of the building, and muttered the following memorable lines, intended for an inscription: 'Should a bank wish to die – preventing it we shall not try.' Initially the goal and purpose of the new institution was to mitigate the agony of financial institutions...*" (1981:5).

While in most countries, institutions similar in type and nature to the Pénzintézetési Központ were only established after the 1929–1933 global economic crisis (e.g. in 1931 in Germany, in 1935 in Switzerland, in 1941 in France), Hungary was among the first in international comparison, which illustrates the proactive nature of financial supervision as well as the excellent ability of the supervisory body to react to the changes in the economic policy environment (*Tomka 2000:81–94*). State supervision had already been in place in several other countries in this period: the supervisory body established in Sweden in 1824 by a royal decree and the so-called "*Comptroller of the Currency*" founded in 1863 in the United States, both of which possessed functions similar to the supervisory duties of the Pénzintézetési Központ) (*Jakabb et al. 1941:28*). In connection with the former, in the interest of a

¹³ Based on Article 7 of Act XIV of 1916 on the Pénzintézetési Központ.

retrospective comparison and an adequate assessment of contemporary conditions we should not forget that Sweden's central bank was established in 1668 and that it had an extensive and relatively developed network of banks even in the early 19th century (its tasks basically included issuing licences and assessing periodical statements). In the case of the latter, due to the unique system of government, the supervisory duties regarding the operation of the individual "national banks" gained prominence early on. In the context of our immediate neighbours, we can say that both the Romanian "*Solidaritetea*" cooperative established in 1898 (comprising 126 financial institutions) and the union of Saxon financial institutions formed in 1903 ("*Revisionsverband*"), which also included several financial institutions, started performing inspections in the early 1900s (*Hantos 1916:89*), although these institutions did not have a resolution function. Here we have to point out a unique supervisory and operational characteristic, namely that according to the Swedish practice, the supervisory body issued operating licences for a fixed period, which had to be renewed after expiry by the credit institution concerned. This practice provided greater leeway for the supervisory authority and encouraged credit institutions to operate more prudently, since withdrawing a licence could be much more complicated for the supervisory authority than not granting (or renewing) it. On the other hand, of course, the available resources (e.g. the capacity of the employees) had to be taken into account, because of the more intensive utilisation of labour in these cases.

In connection with the activities of the Pénzintézeti Központ, some feared that the powers of the state might become too extensive, while others held a diametrically opposed view. From the perspective of efficient state supervision, the latter group regarded the establishment of the Pénzintézeti Központ as a mere "tentative step", which was not sufficient for exercising effective control. This view may have been influenced by the voluntary membership that characterised the first four years of the Pénzintézeti Központ's existence, the large number of financial institutions and the fact that depositors only heard about inspections and their results by chance. In line with the "classical" principles, this segment of the contemporary public wished to exercise proactive supervision by strict measures, directly influencing the business operations of the institutions. According to their proposal, member institutions would have been authorised to accept deposits from clients only if they held a specific sum (200,000 koronas in Budapest, 100,000 koronas in other parts of the country) in government bonds exclusively for securing clients' deposits. Another element of the proposal was that institutions should keep at least 10% of their clients' deposits in government bonds. According to the proposal, only those institutions which held 50% of the amount corresponding to 30% of clients' deposits in excess of triple the amount of the institution's share capital in Hungarian government securities, and 50% in securities deemed by the government as trustee securities, could receive state exemptions (e.g. exemption from duties and

taxes or other exemptions) (*Korányi 1918:560–563*). The proposal did not receive widespread support, probably because of its strict material requirements; however, a number of its elements were included in the amendment(s) to the Act on the Pénzintézetési Központ in some form, if only partially. This was true, for example, with respect to the expansion of the scope of member institutions covered by the inspections. Therefore, the features of the “classical” paradigm became increasingly dominant in the operations of the Pénzintézetési Központ.

5. Summary

More than seven decades passed after the establishment of the first Hungarian bank until the creation of the first integrated supervisory body, following lengthy debates among professionals and the analysis of several foreign examples. In the end, however, the endeavour proved successful. There had already been supervisory bodies in other countries than Hungary, and organisations preceding the Pénzintézetési Központ had been formed earlier there as well. However, the early introduction of the resolution function linked to supervision was definitely unique in the history of banking systems. János Teleszky stated about the novelty of the Pénzintézetési Központ after its establishment that: *“an institution that [...] combines the roles of the inspector and controller with those of the supporter and provider of credit, and that not only identifies problems but can also help right away can be found nowhere else...”* (*Jakabb et al. 1941:6*).

The establishment of the Pénzintézetési Központ on 1 June 1916 and its operational framework did not reflect their final form in the first half of the 20th century. They would continue to be shaped and changed, because *“...just like the bough in Stendhal’s work, [the institution] started to crystallise due to its accumulated duties. And it has continued to do so ever since, as far as I know”* (*Passuth 1981:5*). Of course, objections to the operations of the Pénzintézetési Központ were voiced in that era as well. Yet, when evaluating them, we should take the economic and political circumstances of the age into consideration.

With respect to the operations and scope of activities of the supervisory organisations preceding the Pénzintézetési Központ, we can say that Hungarian supervision shifted from the “Anglo-Saxon” principles towards the “classical” approach, without completely identifying with the latter. In the operations, integrated attitude and detailed “inspection programme” of the Pénzintézetési Központ, we can detect a type of supervisory activity which was close to the “classical” approach, covering even the smaller details. The contemporary professional debates, viewpoints and proposals of that period deserve special attention, since an evaluation of their applicability in the present environment may contribute to boosting the efficiency of supervisory activities.

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