

# Financial Supervision in Hungary between the Two World Wars\*

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*This paper examines the practice of financial supervision in Hungary between the two World Wars, focusing on the period of the Great Depression and the supervisory practice that was employed prior to the crisis and that was transformed as a result. The author would like to establish how the role of the Pénzüntézet Központ as a supervisory body changed after its establishment on 1 June 1916, whether there were other institutions with functions related to the supervisory tasks, and which supervisory tools were used in Hungary during the Great Depression. The paper endeavours to present the contemporary economic conditions and the situation of the financial architecture primarily in line with contemporary thinking, on the basis of the relevant opinions of the experts from the given era.*

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## 1. Introduction

In Hungary, the first integrated, “top-level” supervisory organisation was established during the First World War, on 1 June 1916, when the Pénzüntézet Központ was created. This was considered a remarkable event, since the efficiency of the earlier supervisory bodies operating in varying structural formations (e.g. representative character) with sometimes excessive scopes of activity and competing against each other was questionable in several cases. However, the Pénzüntézet Központ was functioning in an integrated manner, its activities focused primarily on supervisory features, which were supplemented by other functions linked to supervision (e.g. resolution activities).

Before the Pénzüntézet Központ was established, and even after that, numerous disputes and proposals emerged among professionals about its operation, and its activities were often criticised. The Pénzüntézet Központ faced challenges in fulfilling

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its duties from the contemporary foreign and domestic policy developments, namely the First World War and its consequences, then the subsequent establishment of the Hungarian Soviet Republic, the Great Depression and military build-up before the Second World War; all of these developments had an impact on its operation. It is hardly surprising that, as a result of these events, many reform proposals emerged with respect to the functioning of the Pénzügyi Központ, and several of these initiatives were also implemented. Some of these could be considered necessary reform measures, since they improved the efficiency of financial supervision in Hungary, but unfortunately there were a few that set back the development of supervision and hindered the Pénzügyi Központ in fulfilling its supervisory functions efficiently, thereby inviting criticism and attacks.

We now present the general situation of Hungarian financial institutions after the First World War and the changes in financial supervisory practice during the Hungarian Soviet Republic, after which we highlight the reform proposals pertaining to the functioning of the Pénzügyi Központ and the changes in its role. We then demonstrate the effect of the Great Depression on supervision by outlining the practices of the Pénzügyi Központ and other institutions notable from a supervisory perspective.

## 2. The situation of financial institutions after the First World War

During the First World War, “*the concentration of human and material resources [...] for four and a half years left its mark on all walks of life in human society*” (Diószegi 1970:122). The chaotic economic and financial situation, the domestic and international crisis, the transition from the wartime economy to a peacetime economy and the inflation triggered by the war<sup>1</sup> all had a direct impact on the functioning of credit institutions. For example credit institutions’ equity totalled 2.8 billion pengő before the First World War, while during the period of currency stabilisation, it merely amounted to 0.4 billion pengő, and external funds declined from 4.5 billion pengő to 0.3 billion pengő (Botos 1994:25).

After the First World War, 674 banks and savings banks operated on the territory that remained from Hungary, and some of them were characterised by fragmentation, while others were oversized and played a dominant role in economic life. The latter was an “inherited” feature that had been typical of the lending structure before the First World War (Incze 1955:277). The fragmentation characteristic of a portion of the financial institutions, coupled with a public sentiment hostile to banks, naturally triggered calls for consolidation and concentration of these institutions. However,

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<sup>1</sup> The last time the value of the gold korona and the paper korona was the same was in July 1914, then the paper korona depreciated at an increasing pace until the introduction of the pengő in 1927: the proportion was 1:1 in July 1914, 1:43 in June 1918, and 1:14,443 in the second half of 1926 (Teleszky 1927:57; Botos 2002:44–68).

despite the wave of consolidation that started, the general trend in the early 1920s was a rise in the number of financial institutions: there were 962 credit institutions at the peak of the process in 1924 (*Botos 1994:108*). The impact of the Treaty of Trianon on the number of financial institutions could be mainly observed in the case of credit unions: at the end of 1917, 1,562 of the 2,430 institutions (64 per cent) were on the other side of the border. As a result of this loss, the number of credit union members declined by 60 per cent, while savings deposits diminished by 41 per cent (*Schandl 1938:53*). The share of financial institutions' equity that was now outside Hungary on account of the Treaty was 34 per cent of the equity of all institutions operating in 1915, which was obviously due to the dominance of the financial institutions in the capital over provincial financial institutions (*Ács 1936:324*).<sup>2</sup> The concentration in Budapest inevitably increased further as a result of the territorial changes in the years after the Treaty of Trianon, and in 1930, 78 per cent of client deposits, 100 per cent of the debentures and bonds issued and 92 per cent of the loans extended were linked to the capital (*Varga 1928:444*). Even at the end of 1924, the volume of savings deposits and current account deposits amounted to merely 16 per cent of the level before the World War, and it had only risen to 74 per cent by the end of 1929.<sup>3</sup> The maturity of the credit lines provided to financial institutions also changed: in 1915, 65 per cent of all the credit lines were long-term, at the end of 1924 this figure stood at only 5 per cent, and even in 1929 it was merely 30 per cent (*Incze 1955:279*). This substantially increased the liquidity risk arising from the maturity mismatch emerging in connection with satisfying demand for longer-term credit.

The continued operation of the subsidiaries of the banks in the capital across the border was also characteristic, and in this context, the priorities included ensuring continuous capital flows to these institutions, maintaining the earlier financial relations, reducing economic isolation and preserving financial integrity. The operation outside the borders did not necessarily entail negative consequences, since some financial institutions could be described as follows: "*they are now ruled by a foreign power; they are in a better position than immediately after the separation, as the tradition they uphold and the inherent confidence and expertise [...] lend them great strength*" (*Hantos 1930:684*).

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<sup>2</sup> The Hungarian lending structure had already been characterised by the concentration of financial institutions in the capital before the First World War, as the banks in Budapest represented 70 per cent of the total equity and 79 per cent of total external funds in Hungary (*Incze 1955:277*).

<sup>3</sup> When taking into account the difference in the purchasing power parity of the korona and the pengő, the proportion is even less favourable, at 57 per cent instead of 74 per cent.

### 3. Financial supervision during the First Hungarian Republic and the Hungarian Soviet Republic

After the Aster Revolution, the duties of the Pénzügyi Központ included the liquidation of financial institutions, the sale of the securities held by these institutions as well as the potential prevention of lending that would have been against the statute (*Jakabb et al. 1997:52*). Similar to other institutions with a financial institution background (e.g. Országos Központi Hitelszövetkezet [National Central Credit Union], Magyar Takarékpénztárak Központi Jelzálogbankja [Central Mortgage Bank of Hungarian Savings Banks], Kisbirtokosok Országos Földhitelintézete [National Land Loan Institution of Smallholders] etc.), the Pénzügyi Központ became a member of the Takarékpénztárak és Bankok Egyesülete (Association of Savings Banks and Banks, TÉBE), its activities were closely linked to those of the TÉBE, since several duties related to financial institutions (e.g. in connection with consumer protection), were performed by the TÉBE. During the Hungarian Soviet Republic, following the example of the Russian Soviet Republic, banks and later insurance corporations and pension funds were nationalised, and the nationalisation of a given institution was deemed complete when the inspectors sent by the Pénzügyi Központ finished their review.

In line with the one-man leadership policy, the managing director of the Pénzügyi Központ was a so-called people's commissar (later business commissar), and the whole board was abolished. The goal was to make the Pénzügyi Központ the leading bank of the Hungarian Soviet Republic. In addition to the people's commissar (later business commissar), a controlling workers' council and a body of union stewards also operated within the framework of the Pénzügyi Központ, managing its activities together. Eleven specialised groups were created within the Auditing Department to control the nationalised mines and transport, trading and industrial companies. Already in the Hungarian Soviet Republic, a process started that later unfortunately intensified, namely that the activities of the Pénzügyi Központ were expanded by several functions, many of which had not been among its original duties, and some functions were not even linked to financial institutions. For example the management of the finances of the nationalised factories as well as their inspection, or the financial implementation of the furniture sale campaign for young couples, for which a separate Furniture Department was set up within the Pénzügyi Központ (*Jenei 1970:39–45*). During the Hungarian Soviet Republic, the supervision of financial institutions was temporarily assumed by the Pénzügyi Direktórium (Financial Institutions Directorate), however, its members mainly comprised the staff of the Pénzügyi Központ (*Csury-Marosi 1931:194*). But after the Directorate was dissolved in June 1919, supervision was again performed by the Pénzügyi Központ. In connection with the nationalisation of financial institutions, a substantial increase could be observed with respect to the number

of inspections as well as in the number of inspectors. The country was divided into 56 inspection districts, and the representatives of the districts were tasked with the management and inspection of the financial institutions. Yet the activities of the 60 inspectors sent out to review the operation and business management of the financial institutions did not always yield significant results, and the regular inspection at provincial financial institutions was not guaranteed. This lack of success was obviously influenced by the inherited quantitative approach, as the inspectors had to inspect a large number of financial institutions in a relatively short time. For example in case of pension companies, the Pénzintézeti Központ had to inspect 216 entities, completing 60 inspections in 3 months, which, however, can be regarded as substantial. The shortcomings revealed at the institutions under review were primarily linked to wealth and business management and the content of the statutes, and they highlighted the fact that in the case of several companies, financial viability was not guaranteed, therefore their liquidation or merging into another company was warranted. With regard to financial institutions, the Pénzintézeti Központ launched liquidation proceedings at 163 institutions and mergers in several cases. The main reason behind this was not an effort to eliminate the oversized nature or “fragmentation” of the Hungarian financial institution sector, but the ideological position that the financial institution system with the current characteristics was not necessary in the economic order of the Hungarian Soviet Republic (*Jenei 1970:48–52*). However, the measures and the proceedings were not completed due to the fall of the Hungarian Soviet Republic.

#### **4. The initial reforms concerning financial supervision**

Driven by a desire to boost public confidence and mitigate the liquidity risks inherent in the operation of financial institutions, greater emphasis was placed on inspections after the First World War, and the number of inspections carried out by the Pénzintézeti Központ almost quintupled between 1918 and 1929, soaring from 189 to 912 (*Jakabb et al. 1997:117*). The intensified inspections were also necessitated by the renewed anti-bank sentiment after the First World War. In 1922, exaggerating the contemporary situation, Rezső Ruppert, an opposition MP, talked about a bankers’ reign in Hungary: *“We see that this large Hungarian bankers’ organisation that governs our domestic policy as well as our foreign policy [...] dictates our every step, not only in political life, but also in the economic sphere.”*<sup>4</sup> The more frequent inspections were also warranted by the fact that during the First World War and sometimes after that, financial institutions, temporarily relegating their traditional banking activities to the background, were seeking to realise profits on the trade in goods. This was influenced by the substantial reduction in financial institutions’ lending opportunities in wartime, for example the world war

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<sup>4</sup> Based on page 35 in Volume XXVI of the minutes of the National Assembly convened for 19 June 1922

had a devastating impact on debenture lending, as the major debenture markets (especially the Austrian, German, Dutch, Swiss and French markets) contracted (Neubauer 1918:22–24). In addition, the unfolding inflation also encouraged the reduction of mortgage lending – as well as traditional lending – since Hungary did not represent an alluring opportunity for investors due to the turbulent financial situation, and therefore mortgage lending could only really take off after the financial stabilisation (Kovács 2006:89). Especially after the end of the First World War, the alternative activities were encouraged by the fact that the borrowers behind the debentures repaid the loan instalments in the national currency, while banks had to do this in the original currency, which posed a considerable exchange rate risk.

After the First World War, the Pénzintézeti Központ experienced several reforms. Following the World War and the Treaty of Trianon, due to the management of the recurring, substantial and sometimes critical economic issues with respect to the ceded parts of the country, the calls for strengthening financial supervision and extending the Pénzintézeti Központ's activities grew stronger. The role of the Pénzintézeti Központ was also bolstered by the fact that the later unfolding inflation had already become significant in 1918, as *“cash reserves [...] had reached an extreme amount, and the repercussions were hardly predictable”* (Neubauer 1918:22), which also affected the situation of the banking system through financial destabilisation. In connection with the necessity of the reforms, it must be underlined that there was considerable resistance with respect to the establishment of the Pénzintézeti Központ and there were reservations about its activities and the efficiency of its operation. According to some very extreme opinions, the Pénzintézeti Központ was unable to fulfil its original function: due to its *“anaemic nature”*, there was *“absolutely no need”* for its existence, and the 25 million korona paid by the Hungarian State Treasury to create a loss reserve fund<sup>5</sup> went *“down the tubes”* (Neubauer 1918:33). Another example for the “pressure” exerted on the institution was that initially the operation of the Pénzintézeti Központ was limited to merely 5 years, then as a sign of the strengthened confidence and the success of its activities, this was extended to an indefinite term in 1918.<sup>6</sup> One of the substantial changes was that while in 1916 the inspections were based on borrowing or voluntary requests, in 1920 the scope of inspections also covered those members whose share capital was below 40 million korona.<sup>7</sup> The limitation of the scope of inspections by the share capital was warranted by the fact that at that time the inspection system had not been adequately developed, and the inspection of a

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<sup>5</sup> The loss reserve fund was created to support the institutions that were in dire distress due to the wartime circumstances and the economic recession as well as the institutions the assistance of which was in the public interest.

<sup>6</sup> Based on Article 1 of Act XV of 1918 Amending Certain Stipulations of Act XIV of 1916 on the Pénzintézeti Központ

<sup>7</sup> Based on Article 10 of Act XXXVII of 1920 on the Pénzintézeti Központ

financial institution engaged in complex business activities would have required a huge apparatus, which was not available back then (*Jakabb et al. 1997:57*). The development of the inspection system was hindered by the fact that inspection was usually performed as a “second job”, there were few “full-time” inspectors, which was probably exacerbated by the slightly negative attitude towards inspectors and the alarming rumours from abroad about the profession: for example in England, an inspector was sentenced to two years of forced labour after the court ruled that his negligence had caused material damage (*Éber 1912:60*).

In order to further widen the scope of the inspected institutions, only the members of the Pénzintézeti Központ were allowed to accept deposits and handle public funds from 1 January 1921, and at these institutions the Pénzintézeti Központ carried out mandatory inspections (*Tomka 2000:94*). This significantly strengthened the role and economic importance of the Pénzintézeti Központ, and inspired non-member financial institutions towards joining. Another incentive for joining was that public institutions were only allowed to accept surety by a member of the Pénzintézeti Központ. An initiative was born requiring the prior written approval of the board of the Pénzintézeti Központ for cancelling memberships, however, due to the expected dissuasive effect of this on future joiners, the initiative did not enjoy broad support (*Hantos 1916:80*). Possibly on account of the difficulties connected to financing the First World War, the unfolding inflation and the funding of the budget deficit, the amended Act of 1920 stipulated that the Pénzintézeti Központ “*cooperates in satisfying the credit needs of the state, and performs the duties related to government debt with which the finance minister charges it*”.<sup>8</sup> The strengthening function of the Pénzintézeti Központ was also shown by the fact that increasing the capital of the financial institutions with a share capital below 40 million korona and the relocation of the registered seat of the financial institutions was subject to the prior approval of the Pénzintézeti Központ from 1920.<sup>9</sup> From the perspective of financial institution supervision, another major result from the period between the two World Wars was that from 1925, the Pénzintézeti Központ had the opportunity to carry out inspections at its member institutions at least annually (*Jakabb et al. 1997:12*).

The advanced nature of the theoretical and methodological principles of the period is attested by the fact that the Act of 1916 on the Pénzintézeti Központ considered it a priority that the Pénzintézeti Központ should cooperate with respect to financial institutions’ business conduct and business management in order to facilitate the sound development of the financial market, and that this cooperation “*should be based on uniform principles and performed reasonably when possible, and [...] that principles in line with institutions’ nature and the economic requirements should*

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<sup>8</sup> Based on Article 1(5) of Act XXXVII of 1920 on the Pénzintézeti Központ

<sup>9</sup> Based on Article 16 of Act XXXVII of 1920 on the Pénzintézeti Központ

be applied in the business management of the institutions”.<sup>10</sup> This approach is also characteristic of the currently applied supervisory methodology, the pillars of which have become widely known in modern supervisory literature as the so-called “equal treatment principle” and the “principle of proportionality”. These principles represent security and predictability to the market, and therefore they are important parts of supervisory practices.

## 5. The changing role of the Pénzintézeti Központ prior to the Great Depression

Later, some tasks appeared among the activities of the Pénzintézeti Központ that were only partly connected to financial institutions or not at all. This was facilitated by Act XXXVII of 1920 on the Pénzintézeti Központ, pursuant to which the Pénzintézeti Központ “*may take part in enterprises serving the public good and the public interest, and may cooperate in conducting and performing the financial and administrative tasks of economic institutions*”.<sup>11</sup> In addition, its activities were supplemented by managing the financial and administrative tasks of economic related institutions. Within the framework of this, the Pénzintézeti Központ initiated the establishment of several industrial companies, for example in the case of the Fuvárhitelintézet Rt. (Credit Institution of Shipping Rt.) founded in 1925, which was mainly created to introduce lien-backed shipping credit. The Pénzintézeti Központ also took part in the founding of the Molinum Malomipari Rt. (Molinum Milling Industry Rt.) (*Jenei 1970:37*), and in several cases, it also acquired shares in connection with the business management of the institutions and with initiating their establishment. The Pénzintézeti Központ was also designated to perform the resolution of the milling companies (23 in all) within the scope of interest of the Pesti Victoria Gőzmalom (Pest Victoria Steam Mill) in 1926 to prevent its insolvency (*Jakabb et al. 1997:73*). The tasks related to resolution and the financial support provided to the milling companies depleted the resources of the Pénzintézeti Központ. The intertwining ties between the Hungarian banking and industrial sectors through lending were also characteristic before the First World War, and this relationship became even stronger after the war from the side of shareholders and bond issuers; not only banks but also savings banks participated in this role (*Hantos 1930:677*). Nevertheless, the overlap between the banking and the industrial sectors paved the way for the expansion of the Pénzintézeti Központ’s activities from the tasks related to the inspection of financial institutions to those related to the inspection of industrial companies. The Pénzintézeti Központ also had numerous duties in connection with mortgage lending, and here it has to be noted that from 1923, its activities also included the publication of wheat conversion

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<sup>10</sup> Based on Article 5(4) of Act XIV of 1916 on the Pénzintézeti Központ

<sup>11</sup> Based on Article 1(7) of Act XXXVII of 1920 on the Pénzintézeti Központ

prices with regard to the wheat price debenture issues, and the Pénzintézeti Központ also functioned as a so-called trustee<sup>12</sup> (until 1928 together with the Pesti Magyar Kereskedelmi Bank [Hungarian Commercial Bank of Pest]); therefore it also controlled the adherence to the contractual terms until the full withdrawal of the debentures, which demonstrated the strengthening international confidence.

In 1924, measures aimed at the resolution of the finances of the state and stabilising the value of money were employed,<sup>13</sup> which were implemented through the introduction of the so-called “savings korona” as a calculation value,<sup>14</sup> cutting budgetary spending and the overhaul of the system of public services.<sup>15</sup> The activities of the Pénzintézeti Központ were also expanded in this respect, since its tasks now included the settlement based on the calculation value in connection with the introduction of the “savings korona”, as well as the supervision of financial institutions with regard to this. Even when in several cases these additional tasks were linked to the Pénzintézeti Központ’s original duties, they obviously used up resources and hindered the performance of the supervisory activities. In light of this, it is not surprising that a contemporary expert claimed that the Pénzintézeti Központ had “*somewhat departed from the original idea*” with respect to its functioning (*Rassay 1933:421*). There were also internal calls for returning to the Pénzintézeti Központ’s original aims determined by the Act XIV of 1916, and the board discussed this regularly.

The ideas formulated at the time of the Pénzintézeti Központ’s establishment were put to the forefront by Act XIII of 1926, which expanded the group of institutions to be inspected, since the Pénzintézeti Központ could conduct reviews “*at commercial companies engaged in the currency exchange business and securities traders from the perspective of public credit*”.<sup>16</sup> The Act XIII of 1926 enabled the members of the Pénzintézeti Központ to acquire funds not only in the case of bankruptcy, but also when satisfying their credit needs became difficult. The expansion of its tasks related to financial institutions was shown by the fact that in accordance with the Act, the Pénzintézeti Központ played a large part in the mergers between financial institutions.<sup>17</sup> Another task linked to financial institutions was that the Pénzintézeti Központ (together with the Országos Központi Hitelszövetkezet) also

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<sup>12</sup> The person in a position of trust tasked with representing the interests of bondholders. This function was performed by the Pénzintézeti Központ as a mandate until the institution of trustee was incorporated into Hungarian law (in accordance with Act XXI of 1928 on Industrial Debentures).

<sup>13</sup> This is because by this time, inflation had necessitated the introduction of stabilising measures. In 1924, banknote circulation almost tripled in merely three months, but even before that, during the First World War, it had risen tenfold (*Jakabb et al. 1997:68*).

<sup>14</sup> Based on Article 1 of Act X of 1924 on Certain Measures Aimed at Preventing the Depreciation of the Korona

<sup>15</sup> Act IV of 1924 on Restoring Fiscal Equilibrium

<sup>16</sup> Based on Article 1(1) of Act XIII of 1926 on Amending Certain Stipulations of Act XXXVII of 1920 on the Pénzintézeti Központ; earlier these tasks were imposed on the Pénzintézeti Központ by Ministry of Finance Regulations No. 1300/1923 and 6700/1923, and the fact that these became enshrined in law suggests that the Pénzintézeti Központ strengthened from an organisational and functional perspective.

<sup>17</sup> Based on Article 1(4) of Act XIII of 1926 on Amending Certain Stipulations of Act XXXVII of 1920 on the Pénzintézeti Központ

underwrote a counter-guarantee in certain cases when banks undertook surety in the form of a consortium (*Botos 1994:132–145*). This happened, for example, when the financial institutions stood surety for repaying a loan of USD 5 million disbursed by an American financial group and obtained by the Magyar Export Intézet (Hungarian Export Institution) established in 1928. However, the tasks of the Pénzintézeti Központ not related to financial institutions also continued to expand, as from 1926 it “*provides(ed) loans to currently employed and retired public service employees*”.<sup>18</sup> Act XIII of 1926 lacked several of the stipulations from Act XXXVII of 1920, for example the participation in satisfying the credit needs of the state and the participation in enterprises serving the public good and the public interest. The same Act specified that further duties may only be imposed on the Pénzintézeti Központ by law.<sup>19</sup>

## 6. The impact of the Great Depression on financial supervision – Further reforms

The financial crisis and credit crunch in Hungary started in July 1931, although certain signs could be observed even earlier, for example with respect to export revenues, which started to nosedive in 1929, primarily on account of the drop in agricultural product prices (*Kovács 2006:97*). The financial market was already characterised by concentration in this period: in 1929, about 40 per cent of the total equity in Hungary (over 600 million pengő) was controlled by two Hungarian banks, the Pesti Magyar Kereskedelmi Bank and the Magyar Általános Hitelbank (Hungarian General Credit Bank) (*Incze 1955:55*). After the number of financial institutions reached its peak (962) in 1924, it gradually decreased due to the economic crisis, and in 1935 there were 426 functioning financial institutions, while in the last year of the peace, in 1938, there were only 396 (*Holbesz 1939:338*).

Both economic policy measures (e.g. the ordering of a general bank holiday, limiting the payments from savings and current account deposits, the transition from the gold standard to controlled foreign currency management, the imposition of a moratorium on transfers) and supervisory policy measures were introduced to manage the crisis. A portion of these measures was linked together at the institutional level due to the Pénzintézeti Központ, since for example with respect to the moratorium on transfers, the Pénzintézeti Központ acted as the trustee for foreign lenders in the so-called credit fixing agreements (“Stillhalte”) (*Incze 1955:289*). In order to perform its role in the crisis, the Pénzintézeti Központ

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<sup>18</sup> Based on Article 1(7) of Act XIII of 1926 on Amending Certain Stipulations of Act XXXVII of 1920 on the Pénzintézeti Központ

<sup>19</sup> Based on Article 1(12) of Act XIII of 1926 on Amending Certain Stipulations of Act XXXVII of 1920 on the Pénzintézeti Központ

increasingly used its mobility reserves, and in 1931 the total amount of discounted bills rose to 562.7 million pengő from 252.1 million pengő a year earlier.

On account of the economic crisis, 30 per cent of financial institutions operating in the form of a limited company and 10 per cent of credit unions were liquidated (*Schandl 1938:75*), as a result of which the Pénzintézeti Központ's tasks related to liquidation and resolution also increased. By the time of the economic crisis, the Pénzintézeti Központ had gained extensive experience in liquidation and resolution, as there had been other financial institution crises shortly before that. For example in 1927, the Egyesült Budapesti Fővárosi Takarékpénztár (United Savings Bank of the Capital City of Budapest) was on the edge of crisis, and the Pénzintézeti Központ was tasked with preventing a bankruptcy, the reorganisation of the savings bank and its resolution from the loss reserve fund (*Jakabb et al. 1997:82–93*). Dealing with insolvency was also familiar to the institution, as in 1929 the Földhitelbank Rt. (Land Loan Bank Rt.) announced that it was unable to honour its obligations, which was mainly due to its involvement in speculative deals on the stock exchange. However, in this case there was no chance for reorganisation and resolution, thus a so-called composition was concluded. Foreign lenders, seeing the economic situation in Hungary, attempted to take their money out of the country, even at the price of concessions. This, together with the moratorium on transfers contributed to banks' partial resolution (*Varga 1964:63*), and some strengthening in public confidence could also be perceived (*Varga 1933:326*).

During the economic crisis, the emphasis in financial supervision shifted towards the solution of problems requiring immediate action, especially ensuring the smooth repayment of deposits (the Magyar Szavatossági Bank [Hungarian Guarantee Bank] was established in 1931 for this purpose, and its business management was conducted by the Pénzintézeti Központ), and the primary task became the establishment of the upper bound of interest rates that could be applied with respect to banking services by the Országos Hitelügyi Tanács (National Credit Council, OHT) founded in 1931, which was coupled with the Pénzintézeti Központ's inspection and resolution functions. The OHT had partly stipulating, and partly consultative powers: the interest rate determined by it could exceed the bill discounting interest rate of the Magyar Nemzeti Bank (MNB) by up to 50 per cent, and the OHT also set the interest rates for the deposits in savings banks and current accounts. When a financial institution did not apply the interest rate determined by the OHT in its pricing, the OHT, acting in its stipulating capacity, could order the Pénzintézeti Központ to carry out an inspection at the given financial institution. If on the basis of the inspection the Pénzintézeti Központ considered that the financial institution's operation was not maintainable in the future due to its financial and income position, the OHT could order its liquidation on the proposal of the Pénzintézeti Központ (*Jirkovsky 1940:371*). The Magyar Szavatossági Bank, just like

the Pénzintézeti Központ, also had a resolution function: one of its tasks related to this was to provide acceptance credit to financial institutions during their temporary liquidity problems to enable them to meet their obligations, thereby contributing to the continued stability of the Hungarian banking system (*Botos 1994:95*).

The focus of financial institutions' supervision also changed due to the economic crisis. In the second half of the 1930s, a process could be observed, not only in Hungary, that hindered the accumulation of deposits, namely that on account of the crisis of confidence, savings were directly spent on investments by evading banks. As a result, the enhancement of the opportunities for controlling capital formation and capital accumulation gained prominence, just like the fostering of increased deposit formation in financial institutions to promote the "self-financing" of financial institutions. Supporting new deposit placements in financial institutions had already been a priority, since in accordance with the 1920 amendment of the Act on the Operation of the Pénzintézeti Központ, only the members of the Pénzintézeti Központ were allowed to accept deposits from 1 January 1921.<sup>20</sup> Another priority was increasing the control over liquidity, and this was when liquidity considerations became more nuanced: the classification of liabilities, deposits and current account deposits by the level of liquidity (first-, second- or third-grade) was introduced (*Walder 1939:446–455*), and an initiative was formulated – although it was not realised – that in addition to setting the minimum level of liquidity, its maximum should also be stipulated. The increasing prominence of liquidity considerations was warranted by the fact that in the two years after the New York Stock Exchange Crash, American capital in Europe was rolled over for shorter maturities due to the weakened public confidence (the more limited opportunity for acquiring external funds mainly posed problems for provincial financial institutions), thus the frequency of capital inflows became higher, but their amount remained low, and domestic capital formation was also inadequate. In addition, the increase in the volume of deposits did not match the increase in the demand for credit, and therefore financial institutions used almost all their deposits for lending, thereby considerably increasing their liquidity risk, which also contributed to the deepening of the crisis (*Jirkovsky 1940:364*), and the typically deteriorating debtor portfolio also resulted in heightened systemic dilution risk. From the perspective of lending, the initiative pushing the inspection of the so-called "large exposures" in the foreground should be pointed out: a proposal was put forward to follow the most frequent international example and maximise the credit extended to individual debtors in 10 per cent of the share capital. According to the proposal, lending any amount higher than this would have been subject

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<sup>20</sup> This provision, in addition to expanding the opportunities of the Pénzintézeti Központ for inspection, discouraged institutions outside the banking system, e.g. farm industrial units, from accepting savings deposits from their employees. Naturally, there were also non-supervisory tools for facilitating deposit creation in financial institutions (e.g. influencing the level of deposit rates).

to the approval of the board of directors and the supervisory board as well as a notification sent to the supervisory authority. From a credit rating perspective, the renewed emphasis on the proposals linked to guaranteeing the availability of information on debtors (a so-called “evidence centre”) (taking into account bank secrecy as well), which can be regarded as the forerunner to the modern credit information system, had special significance, just like the proposal on developing the regulation on managing the so-called “incompatibility” situations in the case of certain loan transactions where interests were concerned, which was an early form of the current regulation on internal credits and managing conflicts of interest. The idea of establishing an institution fashioned after the contemporary Czechoslovakian “loan protection body” with similar functions as the “evidence centre” had already been formulated in 1926 in connection with the partially jumpstarted lending after the stabilisation of the korona, and this institution would have “*recorded debtors in the form of a credit register*” (Domány 1926:455), but at that time this initiative did not garner widespread support. A cyclicality in the history of supervision is reflected in the approach – obviously in line with the attitude that changed after the economic crisis for understandable reasons – that, with respect to the activities of the financial institutions, similar to certain earlier opinions, supported strict financial supervision and claimed that “*if they cannot perform this responsible and difficult task to the satisfaction of all, they will be constantly in jeopardy of total inspection*” (Walder 1939:465).

During the economic crisis, attacks on cooperatives also emerged, which attributed the critical situation to the state subsidies and tax reductions, sometimes considered excessive, provided to the cooperatives. Others believed that this amount could not be considered substantial compared, for example, to the amount spent by the Pénzüntézeti Központ on the resolution of financial institutions, in fact, the recovery from the economic recession was to be sought in the cooperative idea: “*without a healthy and strong cooperative movement, there is no way out of the economic crisis*” (Wanke 1930:5). The proponents of this attitude also maintained that the public money provided for this purpose was used appropriately. The attacks on cooperatives may also have been triggered by the fact that there was no uniform lending policy on the state support of cooperatives, and therefore in many cases, cooperatives were aided by the state along the lines of a development goal (e.g. agriculture), and as a result, certain cooperatives did not receive support for a long time. This might have been prevented by the establishment of a “top-level cooperative body” or the transformation of the Országos Központi Hitelszövetkezet to ensure the appropriate credit supply, common goods purchases and inspections, as well as the creation of an institution with national jurisdiction representing the interests of the cooperatives, which would have helped facilitate the solution of unsolved issues in connection with the cooperative idea (Wanke 1930:42). However, these proposals were not implemented due to the economic crisis, the prominence

of the measures designed to prevent its deepening, then later the additional tasks that emerged on account of the temporary re-annexations and the subsequent armament.

From a banking supervision perspective, it is important to note that after the crisis, the state issued a regulation every year on preparing the balance sheet, which enabled it to tighten its control over banks' operation. In the next 15 years, commercial banks regularly notified the MNB about their activities, and their FX transactions required approval. The MNB regulated the foreign currency, cash, cheque and credit flows through its circulars and guidelines on implementation (*Botos 1994:44*).

## **7. The change in the scope of activities of the Pénzügyi Központ and other institutions notable from a supervisory perspective due to the Great Depression**

The Pénzügyi Központ had several tasks related to the economic crisis in addition to the inspections, out of which the preparation of the so-called “debt settlement report” in the agricultural sector deserves special mention – within the framework of which the Pénzügyi Központ took part in the settlement of the debt of farmers – just like the business management of the Magyar Pénzügyi Szindikátus (Hungarian Financial Syndicate), an institution in charge of agricultural bond issues.<sup>21</sup> The Pénzügyi Központ also performed public tasks, for example the cross-border settlement of agreements related to the trade in goods and concluded with other countries. It also served the public interest that the Pénzügyi Központ typically spent a certain portion of the supervisory fees paid by the member institutions on social causes, for example it contributed to the Életbiztosítási Rendezési Alap (Life Insurance Settlement Fund, ÉRA) established after the 1936 collapse of the Phönix Életbiztosító Társaság (Phönix Life Insurance Corporation) – which had its seat in Vienna but had substantial Hungarian exposures – to support aggrieved Hungarian parties. The Pénzügyi Központ conducted the business management of several organisations, of which the Magyar Investment Rt. (Hungarian Investment Rt.) established in 1930 deserves special mention, since its aim was to mitigate the impact of the recession on the banking system by preventing the fall in listed securities' prices (*Botos 1994:92*). Act XL of 1928 on the Mandatory Insurance for the Old, the Disabled, Widows and Orphans enabled mandatory insurance in Hungary as well as the creation of the so-called “acknowledged corporate pension funds”.<sup>22</sup> A part of the supervision of these companies (with respect to the assessment of wealth statements and the examination of prudent operation) was performed

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<sup>21</sup> Based on Article 2 of Act XXIII of 1935 on Certain Measures Facilitating the Settlement of Farmers' Debt

<sup>22</sup> Based on Act XL of 1928 on the Mandatory Insurance for the Old, the Disabled, Widows and Orphans

by the minister for public welfare and labour (later minister of the interior) and the Pénzintézeti Központ. From 1 January 1930, the scope of the Pénzintézeti Központ's inspections covered the review of balance sheets from the perspective of insurance considerations as well as the business management of pension funds, and when irregularities were found, a report had to be prepared for the minister.

In 1938, as part of the concentration process characteristic of earlier years, the Pénzintézeti Központ played a pivotal role in the implementation of the merger between the Magyar Általános Takarékpénztár (Hungarian General Savings Bank) and the Magyar Általános Hitelbank. The Tőkepiac Szabályozására Alakult Intézet Rt. (Institution Established for the Regulation of the Capital Market Rt.) was created in 1939 to support the MNB's open market operations, and in addition to assuming a part of its shares, the Pénzintézeti Központ also took control of its business management (*Jakabb et al. 1997:86–106*). With respect to the Vienna Awards between 1938 and 1941 and the temporary re-annexations due to military activities (Zakarpattia Oblast, Upper Hungary, northern Transylvania, Délvidék, etc.) the task of incorporating the financial institutions concerned into the Hungarian lending structure was also assigned to the Pénzintézeti Központ, and this proved to be an especially sensitive area due to the Romanian, Transylvanian Saxon and Hungarian nationalist movements and the economic nation building (e.g. settlement projects, land policy) (*Egry 2006:11; Szász 1966:130–137*).

The increasing engagement of the Pénzintézeti Központ was clearly shown by the fact that after the economic crisis, almost all financial institutions in Hungary were members in the Pénzintézeti Központ, then later Ministry of Finance Regulation 10 of 1939 abolished the existing capital limit on inspections,<sup>23</sup> and member institutions were subject to mandatory annual reviews instead of the opportunity of at least annual inspections. Therefore, an institution with strong authorisation, far-reaching review functions fulfilling supervisory tasks and playing an active role in economic life was gradually developed. During the Pénzintézeti Központ's operation before the Second World War, the number of inspections performed increased sevenfold, and the institution carried out 1,048 inspections in 1940 in contrast to the 159 in the year of its establishment, accordingly its staff was also expanded from 17 to 68. The number of inspections carried out by the Pénzintézeti Központ exhibited a growing trend during the economic crisis, peaking in 1931. The number of inspections in that year (1,096) was never exceeded in the period between its founding and 1940 (*Jakabb et al. 1997:107–117*). However, the number of inspections mainly rose in the case of pension funds (the most remarkable increase happened in 1930 when the figure rose from 92 to 163). In this context, we have to note that pension funds were only subject to inspection from 1927, therefore some inspection "lag" could

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<sup>23</sup> Based on Article 1 of Ministry of Finance Regulation 10 of 1939 by the Hungarian Royal Finance Minister on Extending the Normal Review Power of the Pénzintézeti Központ

be observed compared to financial institutions, which stimulated the increase in the number of such inspections. During the crisis, the number of inspections at financial institutions grew in 1931, from 749 to 802.

After the economic crisis, reservations about financial institutions became widespread among the public, and the tell-tale signs of a crisis of confidence could also be observed. In order to reduce the anti-bank sentiment and restore confidence, a series of presentations was launched in 1935 with the help of the TÉBE, focusing on the situation of financial institutions and the presentation of the contemporary Hungarian economic climate. In addition, the Yearbook of Hungarian Savings Banks and Banks was published, which was supposed to provide credible information to the public by presenting the Hungarian banking policy, credit situation and the corresponding legal and regulatory issues. Similar to the Pénzintézeti Központ, the TÉBE was also forced to deal with more and more issues and problems that were not part of its original functions (e.g. the measures related to anti-Jewish legislations and regulations). And the inclusion of the members, whose number increased as a result of the re-annexations, as well as their integration into the work of the various bodies gave the institution and the Pénzintézeti Központ further tasks (*Botos 1994:35–46*). In later years, the TÉBE's professional opinion was sought and taken into account ever less during economic policy decision-making, therefore it gradually lost its significance, influence and economic role, and a similar fate was in store for the Magyar Szavatossági Bank and most of the organisations representing and protecting the interests of the sector (*Pető-Szakács 1985:116*).

## 8. Summary

Hungarian financial supervision was able to respond effectively to domestic and foreign policy events. In the years after the First World War and during the Great Depression, the risks were basically identified and assessed, and in line with that, the inspection goals were determined, the frequency of on-site inspections increased, the supervisory role of the Pénzintézeti Központ was enhanced, and the inspections covered more and more institutions.

Nevertheless, as a result of a process that could already be felt during the Hungarian Soviet Republic and later intensified, the scope of functions of the Pénzintézeti Központ was steadily expanded, and in several cases it included activities that were hardly linked to financial institutions – or not at all – or to the Pénzintézeti Központ's supervisory, inspection or resolution activities.

Although the idea of returning to the original aim of the Pénzintézeti Központ's establishment emerged several times, the domestic and foreign policy events provided only a limited opportunity for this, resulting in the excessive expansion of the Pénzintézeti Központ's activities and the deterioration of its operational efficiency.

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