THE ORGANISATION OF HUNGARY'S BANKING SUPERVISION (FROM THE SECOND HALF OF THE 19TH CENTURY TO THE EARLY 20TH CENTURY)[1]

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In our paper we attempt to present the early phase in the history of Hungary's banking supervision, from the second half of the 19th century until the early 20th century, i.e. up to and including the establishment of the Pénzintézeti Központ (1916). As a consequence of the peculiar development of Hungary's system of financial institutions, the establishment of banks was preceded chronologically by the emergence of other types of institution (e.g. savings banks, insurance companies), so that naturally the demand for oversight of banks also arose only later and the idea of an integrated system of supervision had not yet surfaced in this period. However, controversies related to financial oversight and the necessity thereof also affected the development of banking supervision. In this paper we look at the opinions, arguments and counter-arguments, specific proposals and initiatives for the establishment of supervisory bodies which led to the emergence of the system of banking supervision. The author of the paper endeavours to present contemporary economic conditions and the situation of the banking system primarily on the basis of the relevant opinions of experts from the given era.

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1. INTRODUCTION

Hungary in the 18th century, as part of the Habsburg Empire, together with many other countries with similar economic and social circumstances, was primarily an agricultural producer state. In Hungary the emergence of banks was preceded by a number of other types of financial institution, such as, for example, the Királyi Hitelpénztár (Royal Credit Fund) established in 1772, the primary purpose of which was to satisfy the state's credit needs and to collect deposits. Although from 1776, depending on its liquidity situation, it was also permitted to grant loans, this facility was mostly available only to a limited range of merchants, rather than to

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the general public. The wide-ranging development of the financial institutional system was hindered by several factors, such as, for example, the monetary shortfall experienced in certain regions. In Sáros County in 1783, for example, fears even emerged of a return to the age of bartering; moreover, in several counties in the south of Hungary, serfs still settled a substantial part of their taxes in agricultural produce. Consequently, deposit collection did not represent a source of funding for financial institutions in these areas, a circumstance which – in the absence of substantial funds of their own – did not generate a pressing need for the emergence of a fundamentally business-based banking system (*Vargha,* 1896:11–32). The development of the banking system was also hindered by the fact that the banks – due to their location and structure – typically preferred lending large amounts, and primarily focused on profit-oriented credit considerations (financial creditworthiness), contrary to cooperative institutions, which also considered *"decent borrower morals and sense of duty"* (*Schandl,* 1938:31) (moral creditworthiness). The cooperative financial institutions, which subordinated business interests to social and moral objectives, gained ground in areas where the earnings potential of economic agents was relatively lower and their borrowing and credit demand was likewise not great, and thus could be satisfied without the need for substantial funds (*Pólya,* 1894:646). Since the members of a cooperative society operating in a given settlement typically all lived in the same settlement, the cooperative society was in the position to expand its activity to include non-profit services that carried no direct business advantage for the members of the cooperative society – e.g. development of the local infrastructure, or facilitating the economic development of the given settlement in any other way (*Botos,* 1996:171) – which in turn all contributed to increasing the population's trust in cooperative societies.

The population's trust in cooperative financial institutions also manifested itself in the case of savings banks, which is also attributable to the latter's core function, as laid down in principle in connection with the start of operations of the Brassói Általános Takarékpénztár (General Savings Bank of Brasov) – established following the example of Nuremberg on 1 January 1836; namely, that the financial institution created solely for philanthropic considerations regarded savings (and the act of saving itself) as a tool of the fight against poverty, and used its business profit for welfare and the support of the Brasov hospital (*Soós,* 1993:115), while also creating a charity fund for needy households. Nevertheless, the savings banks were *"not institutions taking care of the poor or treating diseases, but rather tools to prevent impoverishment and distress..."* (*Vargha,* 1896:88). In Hungary, therefore, the emergence of cooperative financial institutions and savings banks preceded the creation of conventional banks, and consequently requirements related to the oversight of banks also appeared only later.

Another reason the need for oversight related to banks might not have been so urgent – compared to the oversight need urged in the case of cooperative societies and savings banks – was that the Austro-Hungarian Bank participated in the satisfaction of national credit demands, albeit indirectly, with the mediation of the benevolent credit society and the Pesti Hazai Első Takarékpénztár (First National Savings Bank of Pest). Consequently, during and as a precondition of disbursement, the Austro-Hungarian Bank was able to exercise a certain degree of oversight of banks' operations through its refinancing policy from the second half of the 1870s (*Kövér,* 1993:261–267). At the same time, in the second half of the 19th century a kind of concentration process began with regard to the banks, which – due to their increased size and economic weight – pressed for the organisation of banking supervision. As a result of the concentration process, by 1913 the largest industrial, mining, commercial and transport companies belonged to the sphere of interest of a few large domestic banks; in the same year, 225 large industrial shareholding companies belonged to the interests of the five largest banks of Budapest, with total capital of some 711 million crowns representing 51% of the capital of all mining and industrial companies operating in the form of a shareholding company, thereby significantly increasing the influence of the Hungarian banking sector in the control of the domestic economy (*Tomka,* 1999:47; *Botos,* 1994:25). A further circumstance supporting the development of banking supervision was that this period saw numerous financial institutions established as a result of substantial foreign capital inflow and an increased propensity towards entrepreneurship, so that by 1901 there were already 987 banks and savings banks operating in Hungary, increasing to 1,183 by 1905 (*Müller* et al., 2014:9), and increasing still further in the ensuing years.[2]

The development of a framework related to the supervision of banks was fundamentally determined by the identification of risks that already appeared in the case of cooperative societies and savings banks and by the discussion of oversight-related issues; accordingly, the presentation of these is also of some interest from the point of view of banking supervision.

The term "oversight" in this period did not solely mean the state's role in today's sense, but also included fundamentally internal, intra-organisational oversight (self-regulation by the supervisory board) and the exercise of oversight by non-state councils and business federations. In this paper we also present the contemporary role of the supervisory board and the deficiencies in its operation; the various intervening proposals aimed at establishing supervisory bodies; the related professional debates and viewpoints; and the reasons for the initial failure of proposals connected with the organisation of financial oversight.

2 Table 1 shows the evolution in the number of credit institutions in Hungary between 1866 and 1915.

2. THE ROLE OF THE SUPERVISORY BOARD IN THE 19TH CENTURY

In the second half of the 19th century, controls connected with the operation, business and governance of financial institutions essentially belonged among the duties of the supervisory board (*Havas,* 1901:216). However, due to conflicts of interests within the organisation of financial institutions, supervisory boards did not fulfil their role properly (*Lengyel,* 1917:245), while the judicial authorities could only enforce compliance with the relevant laws, at most, which did not in itself ensure prudent conduct. With respect to the operation of supervisory boards, it became the widespread view that their operation is generally unsatisfactory and that a supervisory board was essentially only a "pictus masculus" whose duty was to approve everything. In addition, the general public opinion was that substantial criticism of business management does not belong among its duties, and that its only rights and obligations extend to ensuring compliance with formal requirements, laws and statutes (*Sugár,* 1899:415); that supervisory boards "*signed the balance sheet presented to them without ascertaining the correctness of the items therein,*" or that "*reports of the supervisory board are no longer considered worth reading. And anyway, they are usually not really meaningful*" (*Hantos,* 1916:18). Among other extreme views that could also be heard was that "*in the vast majority of cases, the Hungarian supervisory board is a body of no real value, the fullest quantité négligeable,*" the existence of which is completely unnecessary (*Éber,* 1911:798). This rather superficial practice of oversight was substantiated by Section 195 of Act XXXVII of 1875 (the Commercial Code), which prescribed the inspection of management by the supervisory board not as an obligation, but merely as a possibility. Although principles and requirements related to the operation of supervisory boards already appeared in the second half of the 19th century (e.g. a "permanent functionary" keeping all business areas of the institution under their supervision), views differed regarding the relation of the supervisory board to (state) oversight. One section of expert opinion deemed the operation of the supervisory board necessary only when state control was not implemented (*Kormos,* 1897:11). This expert group – starting from the unlikelihood of introducing state control – wished to increase the supervisory board's controlling role and expand its competences, thereby supporting the "Anglo-Saxon" approach in deeming it necessary to extend oversight based on own internal controls. Opinions with regard to the insufficiently effective operation of supervisory boards also surfaced in later years; in 1911, politician *Antal Éber* – later chairman of the Budapest Chamber of Commerce and Industry and the Hungarian Economic Association – proposed the transformation and reorganisation of the operational framework of the supervisory board. As follows from the foregoing, the internal audit, which was subject to coordination and professional control by the supervisory board, likewise could not fulfil the role of an efficient internal line of defence, particularly in view of the fact that, even in the second half of the 1910s, internal audit duties were typically assigned to the accounting area, and thus the independence of the internal audit was not ensured either (*Hantos,* 1916:33).

As a result of shortcomings related to the operation of control bodies and judicial executive power, demand arose for a kind of financial oversight which does not curtail the operations of financial institutions, does not restrain their development, and performs its functions without exercising any harmful effect on their activities (*Havas,* 1901:213). Since in the second half of the 19th century no institutionalised oversight had yet been established within an organised framework with regard to banks[3], economic thinking focused on the creation of institutions and bodies of various types in terms of organisation and autonomy. Of these – with regard to the details and feasibility of the concept – the idea of creating a so-called expert institution should be emphasised, although other initiatives important in the history of oversight should also be mentioned (e.g. audit committees established on an ad hoc basis, or the Chamber of Savings Banks).

3. PROPOSALS FOR THE ESTABLISHMENT OF SUPERVISORY BODIES

In the Hungary of the 19th century, the theoretical background related to the emergence of the need for oversight, aimed at the development of the financial sector in the longer term, is best illustrated by the relationship to money of *Mór Jókai*, the "romantic capitalist," which also reflects the changing attitudes of 19th century Hungarian society to money. In *Jókai*'s writing, banks and bankers are not portrayed in explicitly negative terms and he did not necessarily condemn monetary transactions and financial undertakings (*Fried,* 2013:150–151). In the works of *Jókai* – who himself acted as a member of the supervisory board of the English Lloyd insurance group's Hungarian subsidiary in order to ensure partial repayment of his debts – money became a central player in the prosaic epic of the 19th century, and through this the lives of a certain class of society. It is an important circumstance in the context of our topic that in *Jókai*'s works this was accompanied by the emergence of a world order where *"as a consequence of proper regulation, awareness and organisation, money can be used as an instrument that*

3 In connection with the oversight of savings banks, the Central Mortgage Bank of Hungarian Savings Banks was established in 1892 at the initiative of *István Tisza*, the primary operational objective of which was to facilitate the access of rural smallholders to credit. In the course of this activity, it established contact only with savings banks that agreed to allow the Mortgage Bank to review their balance sheets and entire business administration annually (Domány, 1926:439 and Botos, 2002:39).

leads not to ruination but, on the contrary, to the preservation of community and the securing of a liveable life" (*Fried,* 2013:157). The change in the concept of and approach to money increasingly called for a certain, not yet specifically defined financial supervision and regulation: *"It is difficult to believe that it was precisely us that God blessed with such an extraordinary maturity in economic policy that – contrary to all other nations – we could do without the contribution of state power in this area"* (*Blum,* 1899:753).

Of the initiatives to establish an institutionalised supervisory body and supervisory control, it is worth highlighting the proposal submitted in the 1870s to the Miskolc Chamber of Commerce and Industry, which raised the idea of the need for mandatory inspection of banks and identification of the causes of bank failures, to be implemented in the form of an autonomous association independent of government (*Jirkovsky,* 1945:176). This form found support among a major section of professional opinion: *"Supervision [...] serves its purpose only in an autonomous way. But on this basis it must be settled in legislative terms later"*; or: "*We should also have no difference of opinion with respect to [...] trying to implement inspection autonomously rather than entrusting it to the state. State inspection here was only supported by the wholly non-professional general public, who obtained information on the benefits of this system from the daily papers"* (*Sugár,* 1899:416 and *Hantos,* 1916:11). *László Lukács*, minister of finance between 1895 and 1905 and later prime minister, as well as *Antal Éber* and *Henrik Trautmann*, a university professor and later director of the Academy of Commerce, also deemed a similar idea feasible for the inspection of financial institutions. Éber wanted to conduct inspections by establishing a central inspection council, in such a way that financial institutions in Budapest and the provinces participating in the council could apply to the body to submit a given financial institution to inspection (*Éber,* 1911:800 and *Éber,* 1912a:55). *Éber* also proposed that any sanction imposed should be of a magnitude that would not hinder the operation of the financial institution (the application of so-called relative sanctions). In the event that the inspection council did not find the continued operation of a financial institution to be "sound," the situation of the financial institution could be made unsustainable by the gradual withdrawal of lending, thereby preventing the systemic consequences of an abrupt shock.

In 1889, almost two decades after the proposal was submitted, the Miskolc Chamber of Commerce and Industry invited the financial institutions in its catchment area to a conference. Several proposals relating to the reform of financial institutions were discussed at the conference – such as the need to review the capital position (e.g. subscribed capital, capital reserves), board of directors and supervisory board of financial institutions – as well as certain accounting issues (e.g. balance sheet compilation). The establishment of an independent supervisory body also featured on the agenda, as did the expansion of the Miskolc conference – essentially a regional-level forum – into a nationwide conference. However, all proposals were unanimously rejected at the conference, as participants regarded the operations of provincial financial institutions as adequate and their operational risks as low. Although in terms of its outcome the Miskolc conference was not a breakthrough for financial oversight, participants from financial institutions came to several realisations that would prove definitive with regard to their later development, and thus indirectly in terms of the history of supervision. Several participants at the conference openly cited a number of problems that they blamed mostly for the failures of savings banks, but from time to time also of conventional banks. The failure of financial institutions was attributed to several factors, in particular to maturity mismatches, the operation of savings banks differing from their original purpose (profit prevailing over social and welfare objectives), and the relatively high interest paid due to strong competition arising from the large number of market players. With respect to the need for state intervention, the typical approach was that of *Adam Smith*'s "invisible hand," as the conference regarded any kind of state intervention as not only unnecessary, but even harmful (*Jirkovsky,* 1945:172–175). The participating financial institutions only found it acceptable to establish an autonomously organised central institution which would elaborate and review certain transaction management and accounting rules, and which would expel member financial institutions that did not comply with the proposals.

No full agreement was reached with regard to the autonomous or state nature and scope of oversight, as we can recognise from the professional debates which emerged following the speech of *Antal Éber* at the meeting of the Hungarian Economic Association on 24 November 1911. *Éber* wished to carry out supervision through the creation of the aforementioned central inspection council, based on prior applications. In the contrasting opinion of *Miksa Havas*, academy professor and chamber inspector, substantial control could only be achieved if performed with regard to all institutions by a state agency or other independent agency appointed by it (*Éber,* 1912a:59). *Havas* therefore took the Austrian normative provisions related to savings banks, adopted in 1844, as the guiding principle, which stated that savings banks belonged under the supervision of the "state government," with a special government commissioner to be appointed to all savings banks who would have full knowledge of their business activity (*Halász,* 1890:780). The opinion of *Havas* was also supported by *Samu Lengyel* (*1917:245*), who took the view that inspection could attain its goal only if mandatory. The position of *Havas* and *Lengyel* was opposed by the influential banker *Lipót Horváth* and *Manó Zsengery*, a member of the supervisory board of the Hungarian National Mutual Insurance Cooperative Society, who also highlighted certain risks of mandatory inspection. They believed that a mandatory inspection, with its opinion of a subjective nature, could have a negative impact on the given institution's reputation and operation, and by "ousting" creditors could also plunge it into a crisis situation. *Zsengery* was of the opinion that it could also have an unfavourable impact on the public, as the public – trusting in the institution of mandatory inspection – presumably would not scrutinise the institution's public accounts, and an excessive, unsubstantiated level of trust could thus develop with regard to institutions inspected by the public authority. By contrast, an optional inspection – apart from being easier to implement – would provide wider room for manoeuvre in respect of the inspection theme, the appointed inspectors and the principles along which the inspection should be conducted. At the same time, *Zsengery* – while recognising the shortcomings of mandatory inspection – came to the conclusion that inspection must be implemented on a mandatory basis, irrespective of the size of the institution, and should also cover the evaluation of corporate governance, but without intervening in business policy. *Sándor Matlekovits*, a lawyer and university professor, and later a member of the board of the Hungarian Academy of Sciences (MTA), regarded the review of specific credit transactions, and indeed any other review going beyond the assessment of the correctness of a balance sheet, as downright harmful and dangerous from a business perspective (*Éber,* 1912b:216). With regard to the rotation enforced during inspections, *Zsengery* proposed implementing this over several years in order to eliminate the extra time and difficulty involved in obtaining the same information on several occasions, which would be inevitable with the appearance of a new inspector as a consequence of frequent rotation. Furthermore, *Zsengery* also highlighted a risk related to the time factor, namely that an inspector could check the data supply only with several weeks' delay relative to the reference date, making the relevance of this data at the given time somewhat questionable (*Éber,* 1912a:64 and 1912b:210). At the same time, with regard to the arguments against mandatory inspection, we should note that the risk attached to opinions of a subjective nature likewise cannot be eliminated in the case of an optional inspection, as it is a risk that can only be mitigated by duly substantiated findings and the conduct of a detailed inspection, while – in the light of subsequent economic events – the disciplinary power of publicity and its ability to scrutinise accounts can be regarded as rather limited. Nevertheless, based on the foregoing, two main approaches should be differentiated even within autonomous inspection. According to the first, the given financial institution may request an inspection at its own discretion, and is exempt from inspection in the absence thereof; while the other approach involves the establishment of a unit that has the necessary competences and may decide on the inspection of a given financial institution based on criteria of necessity and practicability.

Undersecretary *Elemér Hantos* (1916:20–58), the contemporary chairman of the National Association of Financial Institutions, already warned at a financial forum in 1911 about a phenomenon – which unfortunately did occur later, albeit for a short period – whereby, in the case of the operation of a financial supervisory body with relatively weak ability to enforce interests, the conduct of inspections would presumably depend on the member institutions' own decisions, and as such it was precisely those institutions needing to be inspected the most that would evade inspection. Consequently, *Hantos* considered the operational framework of the inspection of financial institutions feasible on a so-called "self-governing" basis in autonomous form (e.g. as a chamber or business federation). In connection with inspections, *Hantos* pressed for a gradual expansion of the circle of inspected institutions and the scope of inspections, starting primarily with smaller institutions (in terms of balance sheet total); among these institutions, he regarded assessment of the adequacy of corporate governance as a particular area to be reviewed. Within this framework, the inspector's duties would have been fulfilled by an external member of the supervisory board belonging to the autonomous organisation, elected for three years. The Hungarian Association of Inspectors, established in 1911 and initially chaired by the then Minister of Commerce *József Szterényi*, could be regarded as such an – already existing – autonomous organisation, qualified as a body in charge of carrying out the professional rating and mediation of inspectors (*Jenei,* 1970:50). Admission to the Association was subject to a minimum eight years of professional practical experience and to successful graduation from a two-year inspector's course covering both academic and practical subjects (*Éber,* 1912b:212). Under this approach, the only financial institutions subject to inspection would have been those with a deposit business and with share capital not exceeding 10 million crowns (in order to strengthen the willingness to undergo inspection within the system of relationships among financial institutions, "subjection" to inspection could have represented an advantage in view of the fact that during interbank lending financial institutions already subject to inspection would presumably have been more willing to lend). The first-mentioned condition was supported by the protection of households' interests, while the latter was justified by the assumption (no longer valid in the present financial and economic environment) that there was less need for "external" inspection of financial institutions that were larger in size and typically pursued complex financial activity. An additional argument for determining an upper limit of share capital for inspection purposes was that inspection required an extremely large administration. Also possibly worthy of consideration was the proposal of *Hantos* with regard to enhancing the professional standards of supervisory boards, whereby a supervisory board would have to include at least one expert whose required professional skills would be specified in a separate decree (*Hantos,* 1916:21). At the meeting of the Hungarian Economic Association at the end of 1911, *Miksa Havas* took a different position on the proposal that inspection should depend on an upper limit of share capital, as he believed that it would be much more important to conduct the inspection of institutions which held deposit portfolios substantially exceeding their share capital (with consequent higher gearing), and which pursued complex business activity (*Éber,* 1912a:59).

Despite all these – often sharp – controversies and professional consultations regarding the organisation of financial oversight, in the second half of the 19th century the idea of institutionalised supervisory control received no response from banks in terms of its practical implementation, although in 1876 Kálmán Széll, finance minister at the time, also emphasised the need for supervision and regulation of financial institutions (*Hantos,* 1916:70). At the same time, the crash of the Vienna Stock Exchange in 1873 – which resulted in the bankruptcy or liquidation of 26 banks and savings banks in Hungary, while, of the five large banks established after the Austro-Hungarian Compromise of 1867, only the Hungarian General Credit Bank survived the crisis with the help of a substantial capital injection – could have given cause for the development of institutionalised supervision. Despite the crisis, the inspection of credit institutions still did not gain weight, something which was probably attributable to the fact that some of the professional players who proposed the organisation of supervision were not hit too hard by the temporary fall in the number of credit institutions – whose number increased substantially in the period of the "Gründerzeit" – in the wake of the crisis. These players followed a so-called free-market approach in economic philosophy, whereby, contrary to bureaucratic coordination, automatic market processes provided sufficient efficiency for adequate operation of the market, and thus – in the opinion of adherents of this economic philosophy – the organisation of supervision could no longer contribute substantially to increasing its efficiency. Below we present the proposals, recommendations and related professional debates regarding the development of supervision.[4]

At the beginning of the 20th century, the idea of developing supervision was supplemented with the idea of its implementation in the form of a business federation, which gained wide support. Of the established business federations, we should highlight the National Association of Financial Institutions in Hungary (MPOSZ), established in 1903, the activity of which is also worth mentioning in terms of subsequently institutionalised supervision, as its tasks included the provision of "*professional guidance with regard to determining correct business principles related to the placement of provincial financial institutions' assets,*" as well as "*the financial and moral support of provincial financial institutions in crisis situations*" (*Botos,* 1994:11; *Jakabb* et al. 1941:31). Apart from MPOSZ, we should also mention the National Association of Financial Institutions (POE), established around the same time, the activities of which included reviewing issues related to domestic credit conditions and the financial sector, the formulation of opinions and

4 Table 2 groups the significant supervisory bodies established or planned in various forms around the turn of the 20th century.

the identification of factors hindering the development of financial institutions, as well as supporting the introduction of standardised practice in bookkeeping and balance sheet compilation (*Müller* et al., 2014:11). Both organisations also had supervisory duties, but the rather broad scope of their activities, the rivalry between the organisations, and the voluntary nature of membership of financial institutions (and thus the voluntary basis of subjection to audits) all contributed to their failure to function as efficient supervisory bodies (*Hantos,* 1916:24).

3.1 The concept behind operation of the expert institution

At the beginning of the 20th century, with respect to oversight of financial institutions, the operational parameters of the so-called "expert institution" were elaborated in detail, where plans called for the experts within the structure of the expert institution – as independent, responsible "functionaries" – to review the functioning of financial institutions on an annual basis. In practice, the expert institution would have operated in a way that an official expert qualification could have been obtained before a so-called review committee. The idea was that (similarly to the presently operating financial supervisory system) the expert institution would be operated by two types of experts, i.e. internal and external members; the external member of the institution would be in charge of conducting inspections, while the internal member performed background, support and analytical tasks. The on-site inspectors, if they found the given institution's accounting records in order, would issue a certificate to this effect; if not, they would prepare a report to the central government, which also had powers to take action. Later on, the principle of rotation to be applied during inspections gave rise to heated debates, because, on the one hand, it was seen as having an important potential disciplinary effect that the inspection of a given financial institution should not be performed by the same inspectors in successive years, but rather – based on the principle of rotation – that the external and internal members should be exchanged, so that an inspector who performed support work in a given period would perform the on-site inspection in another period. The purpose of this was to prevent shortcomings not detected during a given audit from being ignored again during the next audit by an inspector with a vested interest in concealing the error (*Havas,* 1901:214–216). On the other hand, others including *Hantos* (1916:14) supported exactly the opposite idea: *"If the same inspector visits the same financial institution several times, he will gradually become capable of familiarising himself with the situation and individuals sufficiently to be able to assess the value of the presented holdings as well."* In this approach, it was proposed to always perform inspections unexpectedly, without prior notice. From the point of view of the expert institution's operation, it was also important that during on-site inspections, individual inspectors should become specialists in specific areas in accordance with their skills, summarising their inspection findings in openly accessible publications, thereby contributing – in addition to practical skills – to the expansion of theoretical expertise and supporting players in the financial system in achieving prudent operation (*Havas,* 1901:216). The open publication proposed at the beginning of the 20th century in connection with on-site inspection findings could carry relevance in the present as well, because – beyond the previously listed arguments – it could contribute considerably to an increase in supervisory transparency, while simplifying future inspections by providing institutions with the opportunity to remedy existing problems prior to inspection, bearing in mind the content of a previous report on frequent errors and shortcomings.

Another important consideration in the concept of the expert institution's operation was that the inspector should focus on material problems while fulfilling a supportive and cooperative role in the elimination of identified errors. In this period, increased regulation and expanded inspection was deemed necessary in the case of institutions whose bonds were accepted by the state; in their case, the expert institution would have been authorised to review the coverage and management of such bonds. The expert institution would have operated independently of politics, subordinated exclusively to the administrative court. It was also proposed that the administrative court should include economists and mathematicians in order to support the expert institution (*Havas,* 1901:215–219). Based on the proposals, the intention was to organise the expert institution based, in several respects, on the activity of the *Institute of Chartered Accountants in England and Wales*, adjusted to domestic conditions; namely, it was also proposed that inspectors should be members of the supervisory boards of individual financial institutions, thereby also ensuring a certain level of continuous on-site presence. This proposal appeared in similar form in connection with an initiative to establish agencies performing the oversight of savings banks; the idea at the National Council of Savings Banks was to delegate an inspector to each savings bank's board of directors, who would maintain constant liaison with the Council (*Blum,* 1899:756).

3.2 Training supervisors and inspectors of financial institutions

Contemporary general opinion at the beginning of the 20th century also extended to the "upbringing" of expert supervisors and their training in a formal educational context: *"All reform efforts must be implemented by educating the* *suitable forces, as in the absence of these even the most noble intentions and most truthful endeavours will fail...*" and "*we should ensure the education of experts to avoid having to import them from abroad*" (*Havas,* 1901:215). In this period, the education and training of experts with suitable professional skills carried such importance that even later *Hantos* (1916:82) emphasised, in a speech to the House of Representatives on 4 January 1916, that "*men, not measures*" were needed – i.e. the identification of proper experts was more important for the operational success of the institution in charge of financial supervision and inspection than the elaboration of related regulations. The approach in this age was in line with the view on the lessons of history espoused by the political economist *Friedrich List* – who visited Hungary many times, analysed its economic conditions in depth, and deeply believed in the economic development of Hungary – according to which: "*The welfare of nations has been – everywhere and at all times – proportional to the educational level, morality and work of citizens; the volume of goods has always increased and decreased in parallel with the aforementioned attributes...*" (*Sipos,* 1910:37; *List,* 1940:154).

The work of an inspector[5] was clearly separated from the activity of "chartered accountants" as the function of the latter was similar to that of an auditor in the present meaning of the word, while the inspector could, in addition to auditing the books, perform an expert review of the entire business operation and organisation. Furthermore, the activity of the inspector also extended to the review of so-called "incompatibility" situations, which in practice was supposed to identify conflicts of interest (e.g. where the inspector and the inspected person were one and the same) (*Erdély.* 1929:3–18). The wide extent of the inspector's duties is also reflected in the fact that their responsibilities included, in addition to the foregoing, the organisation and reorganisation of business management, asset management, execution of wills and performing of the duties of trustees, as well as the management and implementation of liquidation proceedings. For the implementation of inspectors' education, *Samu Lengyel*, having reviewed foreign examples, considered two feasible options: to establish an independent institution of inspector education, or to add it to the existing framework of higher education. In 1912, the Hungarian Association of Inspectors made a proposal – in the absence of a higher educational institution that could be relied upon, in terms of its existing educational programme and operational frameworks, for the training of inspectors – to establish an independent institution for inspectors' education. *Henrik Trautmann* – a university professor and teacher at several higher educational institutions, and appointed as director of the Academy of

5 In a historical context, we also find early examples of the operation of so-called "professional inspectors." In the international arena, inspectors contributed for the very first time to the establishment – and later the operation – of the Bank of Saint George in Genoa, Italy, in the 15th century, although they had not yet organised themselves into a group at that time (Jakabb et al., 1941:28).

Commerce in Pest in 1921 – elaborated several detailed proposals with regard to the operation of the inspector training institution (its curriculum, admission process, etc.); however, at that time this initiative was not yet widely supported (*Lengyel*, 1917:244–260).

The idea of educating experts eventually gained a broader audience, albeit in a different form than the original idea and only after several years' delay, as in 1929 inspectors were already trained at university level in Hungary. In the same year, as a result of the work performed by chamber inspector *Sándor Erdély*, a so-called *Inspectors' Handbook* was also prepared, which contained detailed guidelines with regard to topics of inspection and the content and related requirements of inspection reports, while also touching upon key aspects of the inspection process and illustrating these using specific examples. However, this inspection activity typically pertained not to the work of inspectors of financial institutions, but rather to the supervision of manufacturing and service providing companies, thus the education of expert inspectors initially also took this form in Hungary. On the other hand, education played a very important role in promoting recognition of the fact that the success or failure of inspection as an institution depended on the availability of highly qualified inspectors.

3.3 Identifying contemporary supervisory requirements and risks

In respect of the banks, both for the purpose of regulation and oversight the primary consideration was the protection of the interests of the household sector, and within this particularly those of deposit holders, as summarised by *János Galgóczy* (1878:23) in 1878: *"As regards the regulation of credit institutions, I would mainly emphasise that deposits should only be placed in short-term financial transactions."* This key objective enjoyed the same priority 40 years later: *"On the other hand, it must be ensured [...] that legislation sees to the relative security of deposits, and primarily those of the average man,"* the explanation for which lay mainly in the information asymmetry between small depositors and larger customers, as well as the fact that *"small depositors are the most anxious, and they transmit their anxiety in a wider circle"* (*Korányi*, 1918:560). A similar requirement was formulated in terms of oversight: *"The purpose of inspection can be nothing but to consider the interests of creditors, and particularly those of depositors..."* (*Éber*, 1911:801). Certain principles of modern financial oversight already appeared in the second half of the 19th century, such as the promotion of prudent activity and responsible lending, restraining of the inclination to take risks and development of financial literacy. For the purposes of oversight, the most important goals were considered to be what *"keeps a person's activity under control, warns superiors* *to act prudently, weakens superficiality and enhances order and accuracy*" (*Havas,* 1901:214), while the basic principles of supervisory inspection included independence and lack of bias (*Halász,* 1890:780).

Based on the provisions of the new German Commercial Code of 1897, specific proposals were made for the mitigation of risk in corporate governance, such as the transposition of the so-called "locus standi" into Hungarian law, based on which it would have been possible to establish the liability of the board of directors when, in the course of its activity, "*it did not proceed with the meticulous care and due skill demanded in the management of foreign assets*" (*Sugár,* 1899:419). In addition, we should also mention a proposal barring the chief executive or any member of executive management from being a member of the board of directors, which argued that "*it cannot be deemed right that where his proposals are criticised [the executive] can participate in the decision with his vote*" (*Sugár,* 1899:421). Another proposal was that the responsibility of members of the board of directors should not terminate with their resignation, but should survive for a certain period thereafter (e.g. until the closing of the next business year). Although these proposals were not yet implemented in practice at that time, several recommendations were made that were integrated into the national law and order by legislation (namely Act XXIII of 1898 on Economic and Industrial Credit Cooperatives). Of these, it is worth mentioning the provision stating that members of the board of directors and the supervisory board must not be related, as well as that specifying that the supervisory board should be invited to meetings of the board of directors with the right of consultation, and that any transaction involving the guarantee of members of the board of directors should be subject to the approval of the supervisory board. In the absence of the notion of regulatory capital, determination of the adequate level and management of reserves and capital elements and the manner of accounting losses were treated as independent, special topics. This was due to the fact that financial institutions would sometimes charge the current year's contingent losses to a separate reserve, rather than to the current year's profits, in order to maintain the level of dividends. In this regard, Section 14 of the 1898 Act on Economic and Industrial Credit Cooperatives contained a provision stating that incurred losses must primarily be covered from the reserve fund (formerly referred to under Section 199 of the Commercial Code of 1875 as a "contingency reserve fund"); however, no specific provisions were formulated with regard to the adequate level of reserves and the manner of managing them, while an initiative calling for reserves to be invested in government securities remained a proposal only.

Hantos (1916:19) warned about the dangers of excessive trust in financial institutions, namely that "*trust is only […] a human trait and not work.*" He also determined the essence of proactive financial oversight, which remains valid today: "*The duty of a real and ideal inspection is to prevent and strangle the causes* *of malfeasance at their birth rather than to detect them after the event, while its most valuable element is the instruction provided by experienced and skilled experts of the centre to the institution's officers, board of directors and supervisory board."*

4. THE INITIAL FAILURE OF PROPOSALS CONNECTED WITH THE ORGANISATION OF FINANCIAL OVERSIGHT

The failure to win acceptance of proposals related to the inspection of financial institutions was attributable to several factors of both a foreign and internal political nature. Among the external political reasons was the fact that, despite proposals for the loosening of economic and financial ties with the Habsburg Empire being formulated as one step of reform endeavours when reform ideas began to mature at the "first" reformed national assembly of 1825/27, the implementation of these proposals did not materialise in practice. A situation thus continued to prevail where the Habsburg Empire aimed to submit Hungary to the standards and authority of the imperial financial system, which on the one hand represented a modernisation of sorts of the Hungarian system of financial institutions, but on the other hand hindered implementation of independent initiatives. The bill elaborated by a committee appointed by the national assembly of 1843 – which then still related to the inspection of savings banks – also remained only a proposal (*Jakabb* et al., 1941:30).

Internal political reasons also contributed to the lengthy process of establishing independent financial oversight, one of which was the War of Independence of 1848, which was also a turning point in terms of economic policy. In connection with the War of Independence, it became the general view that *"the old world ceased to exist, as if swept away by a flood, and in the new world a heavy struggle had to be pursued for the survival of all that was left from the past"* (*Vargha,* 1896:135). The neo-absolutist Bach era that followed the War of Independence also hindered the emergence of proposals related to independent financial oversight, while certain regulatory provisions governing financial institutions – partly due to the resistance of the financial institutions themselves – were still not introduced (*Kovács,* 2006:66). *Gyula Kautz* (1868:485), deputy governor and later governor of the Austro-Hungarian Bank, described the supervisory system of the Habsburg Empire, which existed before the Austro-Hungarian Compromise and was particularly typical of the Bach era, and which primarily impacted public finance issues, but also the entirety of the financial system and Hungarian national conditions: *"During these times the invasion of Austrian financial and policy concepts and regulations was very disadvantageous for us, and the government's petty-minded inspection intervening in all economic matters, the burden of control accompanying financial institutions, the involuntary suspension of national* *legislation, and the controversial circumstance whereby the key objective of most regulations was to ensure the state's absolute power, the interests of the treasury and military or strategic aspects, rather than genuine public welfare, all represented a heavy burden on our country."* In this way, the previously existing Austrian centralised system and the strong influence of Austrian economic policy survived in unchanged form, despite all domestic efforts and the fact that from 1860, prior to the Austro-Hungarian Compromise, proposals urging national autonomy were already spreading in several areas of the economy. Likewise, the substantial constitutional changes that followed the Compromise did not contribute materially to the reduction of Austrian influence and the level of legal and political control. *Kautz* added that, just as in earlier years, the country operated under the reign of similarly oppressive institutions and regulations even after 1860 (*Kautz,* 1868:511), where *"copious decrees, bureaucratic interference, supervision and control"* were the norm (*Kautz,* 1868:288). The Austrian ascendancy over Hungary reflected in this "supervision and control" thus contributed, on the one hand, to the development of the system of financial institutions and the appearance of ideas and professional debates around the organisation of oversight (with respect, for example, to the debates surfacing around Austrian normative provisions related to savings banks, adopted in 1844 and serving as a model for a segment of professional opinion). On the other hand, potent controls over economic policy, the enforcement of "absolute power" and "oppressive institutions" together hindered domestic efforts to organise independent oversight.

5. SUMMARY

Institutionalised oversight could not be implemented before the Austro-Hungarian Compromise of 1867 due to internal and foreign political reasons, but could have developed substantially after the Compromise as a result of relaxation of the Austrian government's restrictive measures. However, in these years the organisation of institutionalised, independent oversight of banks did not materialise, once again due to internal political reasons, as it was prevented in the second half of the 19th century by resistance on the part of the financial institutions themselves, the aforementioned, often unjustifiably high level of trust in financial institutions, and the absence of a consensus with regard to the operation of oversight.

The idea of organising oversight began to take shape at the beginning of the 20th century within business federations. However, oversight organised within these federations did not provide proper and efficient supervision due to the wide scope of activity, overly diverse tasks, rivalry among organisations, voluntary membership and the concomitant voluntary inspection.

Nevertheless, the study of foreign examples and domestic conditions, alongside professional debates within various forums – as well as the occurrence of bankruptcies among banks as a natural phenomenon – all contributed to the establishment of the first supervisory “super-body,” i.e. the Pénzintézeti Központ, on 1 June 1916.

Table 1
Evolution in the number of credit institutions in Hungary between 1866 and 1915

<table>
<tr><th>Type of institution</th><th>1866</th><th>1873</th><th>1880</th><th>1895</th><th>1910</th><th>1915</th></tr>
<tr><td>Banks</td><td>4</td><td>122</td><td>107</td><td>264</td><td rowspan="2">1 828</td><td rowspan="2">2 030</td></tr>
<tr><td>Savings banks</td><td>57</td><td>298</td><td>316</td><td>583</td></tr>
<tr><td>Land mortgage banks</td><td>1</td><td>4</td><td>5</td><td>7</td><td>3</td><td>4</td></tr>
<tr><td>Credit cooperatives</td><td>22</td><td>208</td><td>249</td><td>968</td><td>3 685</td><td>3 780</td></tr>
<tr><td>Total</td><td>84</td><td>632</td><td>677</td><td>1 822</td><td>5 516</td><td>5 814</td></tr>
</table>

Source: Tomka (2000:32) and Statistical Yearbook of Hungary (1918:287)

Table 2
Grouping of significant supervisory bodies established or planned in various forms around the turn of the 20th century

<table>
<tr><th rowspan="2">Type of inspection / Inspection body</th><th rowspan="2">State body</th><th>“Self-supervision”</th></tr>
<tr><th>Non-state, autonomous body</th></tr>
<tr><td>“Optional” inspection</td><td>• Austro-Hungarian Bank
• National Council of Savings Banks
• central inspection council
• review committee</td><td>• Hungarian Association of Inspectors
• Chamber of Savings Banks
• business federation
• autonomous association</td></tr>
<tr><td>“Mandatory” inspection</td><td>• expert institution</td><td></td></tr>
</table>

Source: own design

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