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THE NEW HUNGARIAN BANKING LAW: A COMPARATIVE ANALYSIS OF THE BANKING REGULATIONS IN HUNGARY AND THE EUROPEAN COMMUNITY

I. INTRODUCTION

On November 13, 1991, the Hungarian Parliament adopted a new banking law which came into effect on January 1, 1992.\(^1\) The new law provides for the establishment and operation of commercial, investment, and savings banks in Hungary which are completely separate from the centralized National Bank of Hungary (NBH).\(^2\) One of the many goals stated by Hungary’s Parliament for the new banking law was to encourage more foreign investment in the banking industry in order to further efforts toward a competitive market-based economy.\(^3\) Furthermore, cognizant of its position as an associate member of the European Community (EC),\(^4\) Hungary specifically sought to create bank regulations which would enable full Hungarian EC membership as soon as possible.\(^5\)

The new law is Hungary's latest in a series of reform efforts which endeavor to liberate Hungary from its remaining economic and psychological ties to the former Soviet Union.\(^6\) For the first time since the end of Soviet dominance, which lasted from the 1940s through the 1970s, Hungary’s banking regulations allow non-Hungarians to participate in the banking industry as full owners of new institutions, or as partial owners of existing Hungarian institutions.\(^7\) If successful in its

\(^2\) Id. art. 5.
\(^3\) Id. pmbl.
\(^7\) Act No. LXIX of 1991 on Banks and Banking Activity, art. 15, translated in 2 Hungarian Rules of Law in Force at 1791.
efforts to encourage foreign investment in the Hungarian financial services sector, Hungary not only hopes to persuade the EC to accept her as a full member state, but she also hopes to enter the international economy as a solid independent trading partner for the first time.

However, the major problem regarding Hungarian membership in the EC is that the current EC member states maintain more advanced economic systems, and the EC banking directives are more liberal toward free trade and nonrestrictive banking than the regulations Hungary now has. In addition to the recent stagnation in the Hungarian privatization of state-owned industry, Hungary will soon face stiff competition from foreign banks who will be permitted to take advantage of Hungary's new law to begin servicing the Hungarian financial services sector. Although the new banking law of 1991 was a critical next step in Hungary's effort to modernize its banking system, the law retains many discriminatory provisions which will discourage foreign investment in the banking industry when it is needed most.

This Note will compare the new Hungarian banking law's provisions with the EC's Second Banking Directive to see how far Hungary has come, and how far it still has to go. Part II

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9. The twelve member states that currently make up the EC are Belgium, Denmark, France, Germany, Great Britain, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal and Spain. Nancy L. Kessler, Banking on Europe: 1992 and EMU, 60 FORDHAM L. REV. S395, S395 n.1 (1992). The European Free Trade Area (EFTA) states are not full EC members, but these states have reduced trade barriers between themselves and the EC. The EFTA countries include: Austria, Finland, Iceland, Liechtenstein, Norway, Sweden, and Switzerland. Wegen, supra note 4, at S95. The final group of "near EC" members are the so-called "associated members," including Czechoslovakia, Hungary, Poland, and Turkey. Id. The associated members have negotiated agreements regarding trade promotion, national treatment, and new customs duties among the states in order to gradually work themselves into the EC. Id.

10. See generally Wegen, supra note 4.


12. See generally Wegen, supra note 4.
will discuss the five major periods in Hungarian banking, viewing each change in the context of the political and sociological issues of those periods. Part III will discuss the establishment of the EC, and how EC banking regulations have progressed during the last forty years toward the harmonized state of a single market for financial services today. Part IV compares six specific areas of the new Hungarian banking law with the same provisions from the EC's Second Banking Directive. The specific areas are: (1) the establishment of banks; (2) the country of regulation; (3) the minimum financial standards for authorization; (4) the foreign treatment of banks abroad; (5) the ownership limitations; and (6) the authorized banking activities. Subpart IV.C analyzes the major differences between the two laws in light of the dual Hungarian goals of encouraging foreign investment in the Hungarian banking industry and meeting the EC's general membership criteria as quickly as possible. Part V discusses the observations and implications of the differences between the two laws and their effects on banking in Hungary. Finally, Part VI concludes by stating that although the new Hungarian banking law makes great strides toward encouraging foreign investment in the banking industry, the remaining barriers in the law leave too many disincentives to investment there. The Note then offers some suggestions for how Hungary can bring its banking law into conformity with its stated goals.

II. THE HISTORY OF HUNGARIAN BANKING

The history of Hungarian banking can be separated into five distinct periods. The banking structure in pre-Soviet Hungary was surprisingly well-advanced, consisting of a competitive market industry which served the entire economy efficiently. However, during the second period the Hungarian banking system was nationalized into the Soviet regime of government ownership which thereby removed all competitive forces from the practice of banking, and subjected Hungarians to the Soviet ideology against their will. During the third

14. BEREND, supra note 6, at 3.
period, the disgruntled Hungarians began a comprehensive reform package called the New Economic Mechanism (NEM), during which Hungarian banks escaped much structural change, but suffered further economic setbacks within the ever-weakening economy while trying to maintain strict independence from outside influences. During the fourth period, although the Hungarian reformers hoped that the NEM would be the radical change necessary to modernize Hungary's economy, the government left the banks unreformed, with only piecemeal alterations to arm them against the economic hard times of the 1980s. Finally, during the most recent period, realizing that minor alterations could not solve the major structural problems facing Hungarian banks, the government instituted a major reform in 1987 followed by the new banking regulations in 1991. However, the government still suffers from staunch isolationist tendencies which hold it back from full international integration.

A. Pre-Soviet Banking in Hungary

The social and political backdrop of the earliest Hungarian banking period displayed the cultural ideologies which defined its eventual development. In the 1890s a liberal political party came to power on a platform of Hungarian nationalism which spread into every aspect of Hungarian life. This nationalist sentiment still exists today in the form of systematic discrimination and severe xenophobia in most Hungarian minds. For example, in the early 1900s, the Hungarian legislature passed laws requiring Hungarian to be the official language (while banning others), and the laws made it a crime to hire a non-Hungarian for a job, regardless of the needs of the industry or the qualifications of the employee. Id. See generally Jerome M. Sloan, An Observation of Hungarian Law and Development: Problems and Opportunities 5 TEMP. INT'L & COMP. L.J. 77 (1991). Toward these nationalistic ends, by
During this neo-nationalist period, the economy of Hungary was dominated by several key characteristics. First, and by far the most important, was that the Hungarian raw materials base was absolutely lacking; therefore, Hungary was totally dependent on the benefits of international trade for its survival by importing such necessities as coal, natural gas, and timber. The second key characteristic in the Hungarian economy, which still affects Hungary today, was that most of the labor force was employed in low-paying jobs and therefore had no disposable income to buy anything other than basic necessities. The final key characteristic of this period was that the waning nobility had created a nation-wide credit shortage by overspending and overborrowing to finance their luxurious lifestyles, thus leaving the rest of the country vastly under-capitalized and unable to modernize their industries to become more efficient.

The first Hungarian banks were created during this period as a symbol of Hungarian separateness from the involvement of Austrians or other foreign states. Similar to most other continental European countries, the Hungarian banking system during this period was based on the universal banking model.
different banking need serviced by industry experts within one headquarter building.\textsuperscript{27} The few large banks in Hungary were tightly intertwined with the international banks of other nations, and the rural areas were well served by the local branches, giving full financial services to even the poorest peasants in Hungary.\textsuperscript{28}

The modern National Bank of Hungary (NBH) was established in 1924 as the successor to the Austro-Hungarian bank.\textsuperscript{29} In addition to a well-managed monetary policy, Hungary had a wealth of highly trained and broadly skilled bank officers because each bank employee had to be versed in every aspect of the financial industry.\textsuperscript{30} As a rule, the "correctness and the professionality of banking operations, accounting, calculation, compilation of balance sheets, correspondence, both domestic and foreign" was maintained at very high international standards.\textsuperscript{31} During this period, the Hungarian banking system was on par with most other industrialized nations,\textsuperscript{32} and was very much like the well-run market-based competitive banks in Germany today.\textsuperscript{33}

Because Hungary was a "trading nation,"\textsuperscript{34} there was much foreign involvement in the banking sector monitoring both credits extended to importers, and the efficiency of various export industries.\textsuperscript{35} Despite the seemingly active foreign presence in Hungarian banks, the Hungarian fear of becoming dependent on foreign influences caused a governmental policy which severely restricted foreign bank activities in order to

\textsuperscript{27} Wegen, \textit{supra} note 4, at S107-11.
\textsuperscript{28} Bácskai, \textit{supra} note 26.
\textsuperscript{29} Id.
\textsuperscript{30} Id. at 80.
\textsuperscript{31} Id. at 79.
\textsuperscript{32} Id.
\textsuperscript{33} Id.
\textsuperscript{34} \textit{See generally} Ránki, \textit{supra} note 13; \textit{see also infra} note 152 and accompanying text discussing the German banking system today which leads the world in the universal banking system.
\textsuperscript{35} \textit{See supra} text accompanying notes 20-21 discussing the lack of raw materials in Hungary.
preserve Hungarian nationalism. Even assuming that this international discrimination was morally wrong, the Hungarian economic policies worked, and as of 1929 the economy was quite healthy and may have maintained its strength if it were not for Hungary's dependence on the international trade markets. As a result of the United States stock market crash and plummeting prices in the trade markets, the Hungarian economic framework collapsed as prices and volume of exports fell, foreign creditors called in Hungarian loans, and economic disaster struck. The worse the economic situation grew, the more nationalistic and protectionist Hungarians became. However, nationalism could not protect Hungary from World War II, and by the end of the war, the country was devastated in every area, including its economic and political infrastructure.

B. The Nationalization of Banking Under the CMEA

In 1945 the victorious Soviet Union succeeded in imposing its political, social, and economic systems on all of the physically and economically devastated Eastern European nations, including Hungary, to form the Council for Mutual Economic Assistance (CMEA). However, Hungarians never fully accepted Soviet domination as being a benefit to their country, because they were angry at being forced to succumb to a foreign presence in place of their long fought-for nationalism. Furthermore, Soviet domination reduced the competitive Hungarian economy to a system of centrally planned government-owned enterprises.

36. Id. at 40-41.
37. Id. at 41.
38. Id.
39. Id.
40. Ránki, supra note 13, at 31, 33.
41. SÁNDOR AUSCH, THEORY AND PRACTICE OF CMEA COOPERATION 12 (J. Rácz & G Hajdu trans., 1972). The members of CMEA until very recently consisted of the following nations: Albania, Bulgaria, Czechoslovakia, German Democratic Republic, Hungary, Mongolia, Poland, Romania, and the Soviet Union. Id. at 12 n.1.
42. FED. RESEARCH DIV. OF THE LIBRARY OF CONGRESS, supra note 17, at 46.
43. The four basic elements of any command economy are: (1) elimination of the private owner in favor of state-owned property, Ránki, supra note 13, at 39; (2) direct orders given in quantity to the managers of each firm telling them who
In 1948 the Soviet regime announced the forced nationalization of all industries of production, including banking.\textsuperscript{44} In this Soviet system, the NBH became the central authority for all banking by gaining a monopoly on short-term credit decisions, and it became the direct and almost exclusive source of any type of credit.\textsuperscript{45} The pre-existing commercial banks were all merged into one of three specialized departments within the NBH.\textsuperscript{46} The Investment Bank was authorized only to assign credits for long-term notes from the Planning Board's five-year schedule; the Foreign Trade Bank dealt exclusively with import and export issues among CMEA nations; and the National Savings Bank handled the personal deposits of all Hungarian citizens.\textsuperscript{47} This total centralization limited any transaction, among the trading partners they must export that product to, AUSCH, supra note 41, at 43-44, Ránki, supra note 13, at 36, 39; (3) lack of incentive to increase profitability, quality, or innovation, IVAN T. BEREND & GYÖRGY RÁNKI, THE HUNGARIAN ECONOMY IN THE 20TH CENTURY 223 (1985), BEREND, supra note 6, at 6-7; and (4) pricing systems which plan uniform prices for the entire CMEA, thereby fixing prices for a five-year duration, no matter what factors change to affect the supply and demand of goods and services during that period, AUSCH, supra note 41, at 77, Ranki, supra note 13, at 40.

This quantity based planning completely severs the production process from a realistic valuation of goods or services, as prices only reflect the situation at a Moscow planning session, not the true value of the good in a free market. AUSCH, supra note 41, at 76-77. The pricing system for consumer goods in Hungary was especially bad because it would affect only the demand for a product and never the supply. Ránki, supra note 13, at 40-41. For example, if the plan had under-valued the price of good \(X\), the demand for the good for the entire five-year period would be very high, while the supply of the good would be unable to expand any more than productive capabilities would allow. Thus, the supply would remain stagnant. Similarly, if the price of good \(Y\) were fixed too high, the demand for the good would be very low. The supply as set in the plan was fixed, and could not adapt to the low supply: the only way for the plant workers and managers to be rewarded with bonuses would be to meet and even exceed the quota for that good. The market then would have a surplus of good \(Y\) that nobody wanted to buy, while the vast shortages of good \(X\), which everyone wanted to purchase, would remain. See generally BEREND, supra note 6, at 6; see also infra note 57.

44. BEREND, supra note 6, at 3. Stalin claimed that the banking system in Hungary, although efficient in the competitive market, was improperly formulated to deal with the Soviet goals of industrialization, full employment, and the establishment of collective industries in the CMEA group. Bácskai, supra note 26, at 80. Had the Soviet regime recognized Hungary's strength in the banking market, it could have utilized the system and efficiencies for the good of the entire CMEA. Instead the industry was recreated in favor of a political ideology to the detriment of the CMEA and Hungary itself. Ránki, supra note 13, at 36.

45. Ránki, supra note 13, at 37; see also Bácskai, supra note 26, at 82.

46. BEREND, supra note 6, at 3.

47. Id. Customer service was not an important market indicator during this
private or public, to the goals and policies of the state.\textsuperscript{48} The NBH soon became incredibly slow and inefficient due to its large size and overwhelming communist bureaucracy.\textsuperscript{49}

However beneficial the communist plan for banking looked on paper, it did not function well in practice. By the mid-1950s Hungarians were no longer enamored with the Soviet regime, and their nationalist spirit re-emerged to regain power in their country.\textsuperscript{50} Hungarian economists and non-Communist politicians began to criticize centralized planning in the economy.\textsuperscript{51} János Kádár, the head of the Hungarian Socialist Worker's Party, argued that there was too much administration, bureaucracy, and over-centralization in the system, and he called for the introduction of money market indicators to assure greater independence for each industrialized firm.\textsuperscript{52} He suggested infusing the command system with at least some level of market-based indicators.\textsuperscript{53} However, this centralized system was slow to make any changes, and on October 23, 1956, the Hungarian people rioted in violent protest of the poor economic system they were suffering under.\textsuperscript{54}
C. The New Economic Mechanism

The Soviets soon realized that the problems of 1956 in Hungary were more than mere student rebellions; the entire population was disenchanted with the communist structure. In order to maintain the integrity of the CMEA, Moscow began to allow small reforms in Hungary to appease the unhappy population. Finally, in 1968, the Hungarian government introduced the New Economic Mechanism (NEM) to the Hungarian citizens in an attempt to adapt the economy to the conditions of the international division of labor and to guide investment toward those sectors offering sure economic advantages. Hungarians realized that they had forgotten how to be efficient and how the demand for a product should affect the supply and price of that product. The NEM’s main policies were to concentrate on economic development, allowing for adaptations of the five-year plan if the assumed and real external environment changed, and to “abandon centralized planning in favor of an organic combination of self-regulating market mechanisms” exercised through indirect market pressures.

Although the NEM was billed as the most sweeping reform in the history of Hungary, the NEM included no banking re-

55. FED. RESEARCH DIV. OF THE LIBRARY OF CONGRESS, supra note 17 at 53-54.


57. Márton Tardos, Can Hungary’s Monetary Policy Succeed?, in MONEY, INCENTIVES, AND EFFICIENCY IN THE HUNGARIAN ECONOMIC REFORM, supra note 26, at 64 [hereinafter Monetary Policy].

The period following nationalization, when the role of money was subordinated to the urge to fulfill plans, was not only marked by naïveté but was equally damaging to economic relations. Boosting production often became an end in itself, and as such it did not help meet human needs. Demand frequently remained unsatisfied, and there was nothing to effectively stop the waste of resources and the rapid increase in costs of production.

Id.

58. Bácskai, supra note 26, at 85.

The NEM failed to dismantle the communist centralized infrastructure, partly because the economy was not ready to support such radical change, but also due to excessive lobbying by officials of the various industries (including banking) to maintain their centralized power. Another factor adding to the failure of NEM was that it was too ambitious in light of the political and economic realities of Hungary. The country maintained its fierce nationalism, but at the same time, had to depend on the world market for most imports, especially as it distanced itself from the CMEA export markets of the Soviet Union.

During the NEM, the NBH retained its huge monopoly, while being allowed to play an increased role in financial management. However, the NBH was not yet authorized to refuse loans to development projects which were supported by the government, nor could it refrain from loaning money to enterprises whose solvency and ability to repay was questionable. Therefore, although some effort was made to escape the problems of a planned economy, the informal guidance imposed on banks left the same economic constraints as existed during full Soviet domination.

As the 1970s and the NEM progressed, the economy began to exhibit the deficiencies of a centralized banking system and small meaningless reforms. The Arab oil crisis wreaked havoc on the world market and the Hungarian trading economy. Planners realized for the first time that in order to have an efficient economy, the regulators of the economy (including

61. Bácskai, supra note 26, at 85-87.
63. See generally id.
64. Id. at 58.
65. Márton Tardos, Question Marks in Hungarian Monetary and Fiscal Policy, in 33 Acta Oeconomica 29, 29 (1985), cited in Bácskai, supra note 26, at 86.
66. Bácskai, supra note 26, at 85. One study showed that although a small liberalization occurred during NEM, allowing the NBH to make rational lending decisions ten percent of the time the other ninety percent of loans were plan-oriented investment decisions. Berend, supra note 6, at 179.
67. Richet, supra note 15, at x.
68. Berend, supra note 6, at 194-95.
banks) must be free to adapt to changing circumstances at a moment's notice. They realized that the government's attempt to shield Hungary from world economic conditions could not be continued in light of Hungary's dependency on foreign trade, and that the Soviets' practice of rewarding inefficiency instead of innovation had to be stopped.

D. Bank Reform Efforts in the 1980s

Economic conditions in Hungary during the 1980s were poor due to the world-wide recession as well as Hungarian inferiority in the technological and financial areas. During this period, the government could only attempt to resolve each problem as it arose, and each reform made but a small dent in the centralized Hungarian banking structure. However, from 1981 to 1986, ten small commercial banks were established in Hungary that were separate from the NBH, and these banks were authorized to make lending decisions based solely on rational economic criteria including advanced risk analysis and other modern lending techniques. Two of these banks were even granted permission by the Hungarian authorities to maintain a small amount of foreign investment. Because the Western investors wanted to protect their investment and see it grow, they introduced to Hungary's new bankers the concepts of profit-oriented decision making based on good banking indicators such as profitability and the ability to repay. In early 1984, Citibank became the first foreign bank

70. Id.
71. Id.
72. GÁBOR RÉSÉVEZ, PERESTROIKA IN EASTERN EUROPE, HUNGARY'S ECONOMIC TRANSFORMATION, 1945–1988, at 155 (1990). The Hungarian economy at this time was about twenty years behind other European countries in terms of technological advancement. Id. Furthermore, there was a period of uncontrolled inflation, which caused consistent drops in the real wage level and the standard of living, leaving more than twenty percent of the population living below the poverty level. Brada & Doboz, supra note 59, at 6. Moreover, for the first time, there was a shift in the economy away from the heavy industry which had dominated the job market since the early 1900s, and many people lost their jobs in the massive effort to decentralize and modernize the economy. Béla Balassa, The Next Steps in Hungarian Economic Reform, in Money, Incentives, and Efficiency in the Hungarian Economic Reform, supra note 26, at 37-38.
73. RICHET, supra note 15, at vii.
74. RÉSÉVEZ, supra note 72, at 119.
75. Id.
authorized to conduct banking affairs in Hungary, albeit on very restricted grounds.\textsuperscript{76}

Finally, in late 1984, the government announced its policy for reforming the banking system: it planned to create a system in which functions of bank of issue (bank with the authority to issue currency), state financing, and commercial banking would be separate.\textsuperscript{77} This policy expanded to include the goal of attracting foreign investment in the commercial industries via the use of joint ventures, and by late 1987, there were close to 200 small joint ventures with foreign capital in the banking industry alone.\textsuperscript{78}

However, the Socialist party, which maintained strict allegiance to the ideals of centralized planning,\textsuperscript{79} and a national debt crisis between 1984 and 1987, conspired to slow reform efforts.\textsuperscript{80} Hungary was slowly realizing that her main concerns had to be to attract foreign investment in the commercial industries and to re-educate the population about efficient economic management. It had become painfully obvious that the partial reform efforts of the early to mid-1980s were further hindering the economy instead of helping it to survive.\textsuperscript{81} The government finally instituted a massive reform of the banking system in 1987 which included real opportunities

\textsuperscript{76} RICHET, supra note 15, at 169-70. Citibank operated partially in forints, and was not allowed to underwrite insurance, give credit to Hungarian citizens, or trade in rubles. The bank was allowed only to deal with certain specified commercial transactions. \textit{Id.}

\textsuperscript{77} BEREND, supra note 6, at 254. The government also announced that the general economic policy was to support the "real emergence of more efficient economic activity . . . " by developing a true system of competitive economic management. \textit{Id.}

\textsuperscript{78} RÉSÉVÉZ, supra note 72, at 1-32.

\textsuperscript{79} FED. RESEARCH DIV. OF THE LIBRARY OF CONGRESS, supra note 17, at 118.

\textsuperscript{80} Riding the Tiger, supra note 8; Rough Transition, supra note 8, at 2A; see also Catch a Falling Star, supra note 11. Since Hungary was still completely dependent on imports, and their exports were never enough to finance these purchases, Hungary owed billions to the various economic superpowers around the world. For example, by 1993, net foreign debt was approximately 22.6 billion United States dollars. See Riding the Tiger, supra note 8. Furthermore, the gross domestic debt grew to over 18 billion United States dollars due to the continued permissive environment in the banking industry towards insolvency, obsolescence, negligence, and lack of market performance. Csaba, supra note 56, at 21. For example, during this period, if an enterprise couldn't pay back its short-term loan, the auditors at the NBH would change it from a short-term debt to a long term liability on the balance sheet in order to avoid the firm's default. \textit{Id.}

\textsuperscript{81} Marer, supra note 56, at 57-58.
for foreign money and expertise for the first time.\textsuperscript{82}

\textbf{E. The 1987 Banking Reform}

Based on the horrors of Hungary's economic performance in the 1980s, it became Hungary's new official policy to try to attract the capital and expertise of multinational corporations on a large scale, despite the nationalistic fear of over-dependency on foreigners for their infrastructure or money.\textsuperscript{83} Furthermore, remembering the failures of the NEM and its lack of structural regulatory reform, on January 1, 1987, the banking system was completely re-created and the huge Hungarian monobank was replaced by a two-tiered decentralized system.\textsuperscript{84} The NBH was the first tier of the new system. Its duties were those of a central bank, including controlling the monetary supply, controlling international transactions, and acting as the bank of issue for all credit transactions.\textsuperscript{85} A system of commercial banks separate from the NBH, which work on a competitive profit-seeking basis, formed the second tier;\textsuperscript{86} however, the NBH still directly handled all foreign banking due to the importance of maintaining strong relations with Hungary's trading partners.\textsuperscript{87} Since these new banks were required to be profitable, the 1987 law suggested certain minimum standards for making lending decisions. Therefore, before a bank could loan any money to an enterprise, the bank would consider both the profitability threshold and the general economic well-being of this firm to determine its ability to repay the loan.\textsuperscript{88}

\textsuperscript{82} Id. For a general description of the relevant banking law and reforms, see FED. RESEARCH DIV. LIBRARY OF CONGRESS, supra note 17.

\textsuperscript{83} Marer, supra note 56, at 59; see also supra note 19 and accompanying text.

\textsuperscript{84} FED. RESEARCH DIV. OF THE LIBRARY OF CONGRESS, supra note 17; DEWEY BALLANTINE THEODORE GODDARD, supra note 17, at 80; BEREND, supra note 6, at 270; see also Kim Reisman, Note, The World Bank and the IMF: at the Forefront of World Transformation, 60 FORDHAM L. REV. 349, 365 (1992).

\textsuperscript{85} BEREND, supra note 6, at 270.

\textsuperscript{86} Id.

\textsuperscript{87} FED. RESEARCH DIV. OF THE LIBRARY OF CONGRESS, supra note 17, at 126. Hungary was spending sixty-five to seventy percent of all foreign currency just servicing its trade deficit to the West and decided to maintain a uniform national policy toward its growing international debt. Id.

\textsuperscript{88} RICHET, supra note 15, at 137. The profitability thresholds were based on figures between seven and twenty percent, depending on the industry.
The new law had several important effects on the banking sector. For the first time, managers of banks were required to be realistic about the various market forces such as supply, demand, and profitability. The banks were now free to lend money to whomever they decided was the best risk, and were not forced to give loans to inefficient enterprises because of a government plan.\textsuperscript{99} The credit banks were also free to collect the deposits of the same customers to whom they lent money, thereby better servicing their customers.\textsuperscript{100} If a bank were profitable, the government would impose a newly written income tax on the profit. However, for the first time, if the bank was losing money, it was to be held accountable for the losses and not subsidized by the government.\textsuperscript{101} Furthermore, the population of Hungary was now given its choice of competing banking institutions, which meant that the banks had to invoke some service initiatives for the first time to attract and maintain customers.\textsuperscript{102}

However, the 1987 reform was not to be the last of the regulatory revisions. It was soon obvious that the NBH still maintained too much control over the financial services sector. In fact, in 1991, the NBH owned almost half of the total outstanding stock of the six largest Hungarian banks.\textsuperscript{103} Furthermore, the commercial customers of the banks (the various Hungarian enterprises) also often owned large percentages of shares in the banks, placing the customers in a position to depend on unfair leniency from the bank officials.\textsuperscript{104}

In June 1988, Hungary signed a ten-year agreement with the EC which would progressively reduce the barriers to trade between the two parties.\textsuperscript{105} However, this put pressure on

\textsuperscript{89.} Balassa, \textit{supra} note 72, at 46-47.
\textsuperscript{90.} \textit{Id.} Under the previous system, the enterprise had to go to the Investment Bank for a loan, and the National Savings Bank to deposit any savings.
\textsuperscript{91.} \textit{Id.}
\textsuperscript{92.} Tardos, \textit{supra} note 57, at 72-73.
\textsuperscript{93.} \textit{Hungary's New Banking Law, supra} note 8. The NBH held the following amounts: Hungarian Foreign Trade Bank (44%), Hungarian Credit Bank (49.3%), Budapest Bank (41%), National Commercial and Credit Bank (35%), General Banking and Trust Co. (50%), and Industrial Development Bank (68.75%). \textit{Id.}
\textsuperscript{94.} Csaba, \textit{supra} note 56, at 22. This state of affairs is called the "Yugoslav Syndrome," because most of the Yugoslavian financial services market is owned by a few large industrial monopolies who have the power to lobby for loan forgiveness on a regular basis. \textit{Id.}
\textsuperscript{95.} Steven Nisbet, \textit{EC Leaders to Help E. Europe On Road To Join EC}, REU-
Hungary to look at its past and continuing failures in all areas of reform, and impose radical structural-level changes in the banking industry.


In the late 1980s and the early 1990s, Hungary finally realized that due to its dependency on foreign trade, it had to create an internationally efficient banking and financing structure. The Hungarian government also realized that each time it attempted to shield the various industries from increased foreign competition, it rewarded inefficiencies, and made the already burdensome trade deficits larger and more

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TERS NEWSWIRE, June 18, 1993, available in WESTLAW INT-NEWS-C FILE.

96. Hungary was once considered the darling of the Eastern European nations because of its early grand scheme to reform the country into a competitive market-based economy. Catch a Falling Star, supra note 11. However, efforts at decentralization and privatization in the business field have stagnated, while the population of Hungary is suffering under living standards which as of July 1993, are twenty percent lower than they were in 1987 and unemployment which is fourteen percent higher and rising. Where Patience is a Virtue, THE BANKER, July 1993, available in LEXIS, BANKNG Library, FINTME File [hereinafter Patience]. Add to that a world-wide recession, and the reformers in Hungary were sure a major change needed to occur. Id.

However, a large continuing problem for Hungary is that she does not have a competent labor force to succeed in Western-style firms requiring accounting, financing, and a competitive and innovative spirit. Foreign companies who do come to do business in Hungary often maintain a policy to only hire Eastern European employees in their twenties who "still have initiative and [who] can learn, unlike those with 15 years' experience in the state sector." Ken Kasriel, Sony Finds Foot- hold in Hungarian Markets, BILLBOARD, Aug. 7, 1993, at 37; Sloan, supra note 19, at 78. However, as Hungary continues to induce more foreign investment into the country, highly skilled specialists will no doubt follow to establish a structure for the westernization of the Hungarian labor pool. Nigel Ash, Hungary: Privatization Programme Needs an Overhaul, REUTERS TEXTLINE--EUROMONEY SUPP., April 15, 1992, available in LEXIS, NEXIS Library, EURRPT File. For example, there is a Canadian program which brings retired and unemployed executives from the United States and Canada to volunteer in Hungarian firms to help them adapt their philosophies and practices to Western standards. Neville Nankivell, Hungary: Volunteers Tackle Eastern Europe—Unemployed Executives Hard at Work, FIN. POST, August 14, 1993, at 9, available in WESTLAW, INT-NEWS-C File. Hungarian officials hope that the accumulation of these efforts in conjunction with increased foreign investment in the banking sector will speed up the process of westernization so that the EC will begin membership negotiations soon. Visegrad, supra note 5, at 1.

97. FED. RESEARCH DIV. OF THE LIBRARY OF CONGRESS, supra note 17, at 149-50.
difficult to maintain. Using their knowledge of these past failures, while keeping in mind Hungary's refusal to become subordinated to foreign pressures, the Hungarian legislature created the new banking law to attempt to deal with these past problems and future goals.

On November 13, 1991, the Hungarian government passed Act No. LXIX of 1991 on Banks and Banking Activities. As a whole, the act provides the legal framework for the establishment and operation of commercial and retail banks other than the central and international banking institutions in Hungary. It creates a banking structure that accommodates many different types of internationally competitive banking institutions for the first time. The goals of the law are two-fold: to implement the new governmental policy of encouraging foreign investment, and to bring Hungary within the provisions required of EC banks in order to facilitate more trade talks.

The law addresses six main areas: (1) the establishment requirements for banks in Hungary; (2) the Hungarian regulation of any foreign-owned banks; (3) the minimum financial standards required for the establishment of any bank; (4) the treatment required of foreign countries towards Hungarian banks abroad; (5) the ownership limitations of banking institutions in Hungary; and (6) the limit-
ed types of banking activities authorized in Hungary.\textsuperscript{108}

III. EUROPEAN COMMUNITY LAW

On January 1, 1958, the Treaty of Rome entered into force, establishing the European Community (EC) among the nations of Belgium, France, Italy, Luxembourg, the Netherlands, and West Germany.\textsuperscript{109} The main objective was to provide for a single economic central market for European trade and commerce.\textsuperscript{110} The founding nations had been totally devastated by World War II, and their desire to maintain national sovereignty\textsuperscript{111} was overcome by the hope that "the nations of Europe, tempered by centuries of war, [could] mature into a peaceful trading partnership."\textsuperscript{112} The main goal of the EC was, and is today, to combine the best resources of each member state to create the most efficient economic system possible for the betterment of all nations involved.\textsuperscript{113}

However, in order to establish commonalities among the member states, the varying internal laws of each nation had to be harmonized to the least common denominator.\textsuperscript{114} To achieve this common market, Article 3 of the Treaty of Rome provided three main objectives for the Community: the elimination of customs duties, the abolition of obstacles to freedom of movement, and the harmonization of municipal laws to assimilate the markets of all member states.\textsuperscript{115} Because the enactment of any legislation requires the unanimous adoption

\textsuperscript{108} Id. art. 33, translated in 2 Hungarian Rules of Law in Force at 1801-02.
\textsuperscript{109} TREATY ESTABLISHING THE EUROPEAN ECONOMIC COMMUNITY [EEC TREATY].
\textsuperscript{110} Mark A. Goldstein, 1992 and the FCN and OECD Obligations of EEC Member States to the United States in the Financial Services Area, 30 VA. J. INT'L L. 189 (1989).
\textsuperscript{111} Id. at 190.
\textsuperscript{114} Id. at 624.
\textsuperscript{115} Uwe H. Schneider, The Harmonization of EC Banking Laws: The Euro-Passport to Profitability and International Competitiveness of Financial Institutions, 22 LAW & POL'Y INT'L BUS. 261, 264 (1991); see also EEC TREATY, art. 3.
by the EC's Council, each country can block a directive if it feels that the law does not sufficiently address its individual needs. This effective veto makes harmonization a very slow and painful process of continuous compromises.

In the mid to late-1980s, the White Paper set out the EC's most sweeping reform efforts to date toward its goal of creating the Single European Internal Market. The White Paper established a timetable for removing all remaining nontariff barriers (such as discriminatory legislation in member states) by 1992, and included the harmonization of the financial services industry on a Community-wide basis.

A. General EC Concepts and Provisions

In order to effectuate the full harmonization of laws among the member states, Article 52 of the Treaty of Rome provides for Freedom of Establishment. Article 52 states: "restrictions on the freedom of establishment of nationals of a Member State in the territory of another Member State shall be progressively abolished" in the course of a transitional period.

Thus, following the transition, all EC citizens were entitled to establish business undertakings as freely throughout the EC as he or she was allowed to in his or her own nation. This "Freedom of Establishment" was then further specified in a Council Directive obligating all member states to abolish any

117. Id. at 195-97.
118. Opinion 'On Completing the Internal Market'—White Paper from the Commission to the European Council, 1985 O.J. (C 344) 16 [hereinafter White Paper]. The four goals of the Internal Market are to maintain free access to national markets for goods, mutual recognition of state laws, minimum harmonization, and home state control. Schneider, supra note 115, at 266-67.

The European Commission (the legislators of the EC) issued the White Paper in 1985, listing the various stages which would need to be completed before the "Internal Market" could be complete. They set a deadline of 1992 for the complete harmonization and adoption of the Single European Act throughout Europe. Kessler, supra note 9, at 396-97. It was in the White Paper that the EC first stated its goal of mutual recognition of each member state's laws as the most efficient way to become a truly common market. Kessler, supra note 9, at 397.

120. EEC TREATY art. 52. Article 59 then went on to state that restrictions on the freedom to provide services within the Community would also be progressively abolished. Id. art. 59.
restrictions on foreign participation in banking and savings and loan undertakings. The goal in the EC today is to establish a “single market” specifically for financial services. The Community hopes to accomplish this single market in three ways: (1) by harmonizing the essential supervision of banking for the protection of investors; (2) by mutually recognizing each member state’s application of those banking standards; and (3) by maintaining home country control over financial institutions operating in other member states. In order to meet these lofty goals, the EC passed two key banking directives—the first in 1977, and the second in 1989.

B. The First Banking Directive

One of the first priorities of the EC’s banking directives was to set certain uniform minimum standards for all banking institutions in the EC. According to the First Banking Directive, each national of a member state who wishes to establish a credit institution in another member state must first obtain authorization from that state by meeting threshold requirements such as minimum funding, and ownership criteria. After satisfying these minimum requirements, the Free-

122. Kessler, supra note 9, at 397. See generally Schneider, supra note 115, at 269.
126. First Banking Directive, supra note 123, art. 3; see also Kessler, supra note 9, at 400 n.30. The requirements for authorization listed in the First Banking Directive are the following: a minimum amount of separate “own” funds (art. 3(2)), two directors of the bank “who effectively direct the business of the credit institution” (art. 3(2)), and strict disclosure and supervision provisions to monitor liquidity and solvency (art. 7(1)). First Banking Directive, supra note 123, art. 3(2), 7(1).
dom of Establishment clause provided by the Treaty of Rome permits that institution to set up as many offices or branches of that bank as it wishes within the same country with no further authorization necessary. Moreover, authorization must be granted on the basis of nondiscriminatory national treatment, i.e., the foreign institution must be evaluated under the same standards as those applied to a home state institution. Finally, the First Banking Directive left all governmental control of the bank to the "host" state, the state in which the bank is located. This provided a strong incentive for banks seeking to invest abroad to forum shop for the EC host nation with the least intrusive banking regulations.

Although the First Banking Directive liberalized many of the procedures previously required to establish a bank after its acceptance by a member state, many significant restrictions on foreign participation in the financial services sector remained. First, EC institutions had to obtain authorization from each separate member state before being permitted to participate in any banking activity in that country, even if that institution had already received authorization in another EC state. Second, the institution was subject to supervision by the host country, and thus, may have been limited in its scope of business activities by the host country's laws. Finally, the First Banking Directive did not liberate the procedure required for non-EC nationals seeking to set up financial institutions in member states.

These remaining obstacles to foreign participation in the

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128. First Banking Directive, supra note 123, art. 4; Hymas, supra note 125, at 1691-92.
129. First Banking Directive, supra note 123, art. 4; see also Schneider, supra note 115, at 272 (ninth principal).
130. Kessler, supra note 9, at 399; see also First Banking Directive, supra note 123, art. 3(1).
132. First Banking Directive, supra note 123, art. 9(1); Kessler, supra note 9, at 399. A non-EC national was left to the discriminatory legislation of the various member states, and was required to receive national permission before opening up each and every new banking institution.
financial services sector were inconsistent with the lofty goals of the Treaty of Rome, particularly the "Internal Market." The theory behind the EC was to create a uniform single market without barriers of any kind. However, the First Banking Directive, while comprehensive in its scope, left many barriers within the EC untouched. After all, one of the so-called pillars of the single market is the removal of member state barriers to allow for financial services throughout the European Community. Thus, the obstacles remaining in the First Banking Directive had to be eliminated.

C. The Second Banking Directive

In an effort to remedy the shortcomings of the First Directive, in late 1989, the EC's Council passed the Second Banking Directive. The Second Directive sought to move the EC closer to its goal of a fully integrated single market in the financial services market than had the First Directive. The Second Banking Directive effectively removes all restrictions in the establishment of banking institutions by EC nationals as well as non-EC nationals. This freedom of establishment is

133. See supra note 118.
137. See Second Banking Directive, supra note 124; Kessler, supra note 9, at 400.


139. See generally First Banking Directive, supra note 123. The First Banking Directive had required a separate authorization for new banking institutions in other member states (art. 3(1)), subjected out-of-state banks to the laws of the host state (art. 4), and failed to liberate the procedure by which non-EC nationals could get an EC banking license (art. 9(1)). First Banking Directive, supra note 123, arts. 3(1), 4, 9(1). By comparison, the Second Banking Directive authorizes
known as the “Single Passport,”\textsuperscript{140} and operates by allowing any institution which meets the minimum requirements in any one state immediately to gain the right to operate throughout the entire EC.\textsuperscript{141} Thus, under the Second Banking Directive, any credit institution which is authorized to do business in the financial services market in any EC member state will be able to establish branches and offer its services freely throughout the entire Community.\textsuperscript{142}

The Second Banking Directive addresses six main areas: (1) the Single Passport establishment concept;\textsuperscript{143} (2) the regulation of the bank by its “home” country;\textsuperscript{144} (3) the minimum standards required before being granted a license;\textsuperscript{145} (4) the requirement that EC banks in non-EC countries be given “reciprocal” treatment by that host state;\textsuperscript{146} (5) the complete liberation on the amount of stock any party can maintain in the banks;\textsuperscript{147} and (6) the allowance for “universal banking” authorizing EC banks to engage in almost any banking or financial activity.\textsuperscript{148}
D. Banking in the EC Today

Generally, the EC member states are hopeful that the Second Banking Directive's approach will ultimately prove beneficial. However, because EC Council directives are not self-executing, it will take some time for the many banking barriers to be eliminated from the national laws of the European nations due to the stubborn nature of national traditions. Before the Second Banking Directive was fully implemented, most EC banks, preparing for the increased competition expected from the formation of a single market, tried to fortify their market share in hopes that their financial strength would protect them. However, many believe that the regionalist trends of language and culture which were prevalent historically will persist, and that banking products will continue to be offered in regional areas, thereby eliminating the possibility of one huge Pan-European bank to serve the entire EC. Furthermore, because some EC nations are better poised to take advantage of this new directive than others, some EC states fear that their banks will drown in this new financial ocean of possibilities.

For example, banks in Germany and the United Kingdom are well situated to take full advantage of the integrated market because their systems already allow them to offer the full range of services (i.e., universal banking) authorized in the Second Banking Directive. Luxembourg is also well poised

149. Kessler, supra note 9, at 412.
150. Gordon Platt, One-Mart Banking in Europe Nearing, J. COM., Feb. 26, 1988, at 1A; available in LEXIS, NEXIS Library, JOC File. The smaller banks are merely looking to form alliances, while the mega-banks like Deutsche Bank in Germany are already buying up banks in newly opening markets. Id.
151. Kessler, supra note 9, at 412. Kessler explains that the various regions will be a German group, a French group, a British group and a Danish group. Id. at 412 n.170; see also Arthur E. Wilmarth, Jr., Too Big to Fail, Too Few to Serve? The Potential Risks of Nationwide Banks, 77 IOWA L. REV. 957, 968 (1992).
152. Kessler, supra note 9, at 414; see supra note 26 and accompanying text for a definition of universal banking. Both of these banks have used universal banking for years very efficiently, and their experience and existing market share will make them almost indestructible in the early years of the single banking market. Platt, supra note 150. German banks can not only engage in investment banking and deposit taking, but they may participate in real estate, insurance, travel agency, gold banking, and nonbanking activities. Schneider, supra note 115, at 279. Germany is considered the most liberal in the evolution of universal banking. William Boger, III, Banking Reform in the 102d Congress—Glasnost for Glass-
for the integration, because it has traditionally had very loose regulation and has historically welcomed foreign banking participation in its domestic financial markets. Belgian, Danish, and Dutch banks, while retaining some weaknesses from their formerly centralized systems, are generally very well capitalized and efficient, and are expected to meet the EC requirements easily, though their relatively smaller sizes may hurt them competitively against the super-banks of Germany and the United Kingdom.

By comparison, Spanish, French, and Irish banks are not yet prepared to meet the requirements of the highly competitive single passport system because of the painfully slow process of deregulating their formerly centralized systems. Furthermore, banking in these countries tends to be very expensive locally, even if their banks do compete somewhat internationally. Finally, the banks in Italy, Portugal, and Greece are not prepared for the competition, and most believe that the single market will destroy these government-controlled, inefficient, and poorly capitalized banks, despite the

153. Kessler, supra note 9, at 414.

Some economists are concerned that a "race to the bottom" will occur in the EC. This race occurs where each member state attempts to have the least intrusive banking regulations, which will in effect, create a lack of stability in the laws. The race to the bottom has turned into a reality in American corporations law. Delaware's state incorporation laws are very liberal in the hope that they will attract more companies because the fees and taxes collected are a huge source of revenue for the state. Delaware has apparently won the race because they maintain the largest percentage of all incorporated companies in the country, despite its small size. JESSE H. CHOPER ET AL., CASES AND MATERIALS ON CORPORATIONS 17-18 (3d ed. 1989). Critics of the race to the bottom argue that such loose corporate regulation does not benefit the small shareholder, but is merely for the selfish interests of the board of directors and large owners. Id.

154. Kessler, supra note 9, at 414.
155. Hugh F. Hall, International Law, in Developments in Banking, 1993 ANN. REV. BANKING L. 189, 210-11. In fact, French banks have been nationalized since 1946, and the liberalization and privatization process has been slow. The government still has much control, if not overtly, then indirectly through policy power. Id. Similarly, the banks in Italy are still very influenced by the fears of the Great Depression and their banking activities are very restricted by overly strict regulation. Schneider, supra note 115, at 279.

156. Kessler, supra note 9, at 415-16.
benefits that will flow to the other industries and private parties in these nations.\textsuperscript{157}

IV. COMPARISON

Both the new Hungarian Banking Law and the EC's Second Banking Directive seem to address the same basic issues in their provisions, but at the same time they maintain several critical differences. While it is important to note the textual differences between the laws, it is more critical to view the effect that these differences will have on the banking markets in Hungary, in light of Hungary's goals of encouraging international investment in its banking system and gaining full EC membership.

A. Hungarian Banking Law Provisions

Hungary enacted the new banking law in 1991 in response to the critical economic situation in the late 1980s and early 1990s. The Hungarian Parliament implemented the new plan with three main purposes in mind: to “encourage savings and increase the confidence in banking institutions of depositors and investors; ... [to] facilitate the regulation of banking activity with a view to promote free enterprise; [and to] gradually integrate the Hungarian banking system into the international one ....”\textsuperscript{158} The various provisions of the law attempt to liberalize the procedure for both domestic and foreign establishment of banks in Hungary, to encourage foreign investment in Hungary, and to help the domestic economy recover from years of suffering and neglect.\textsuperscript{159}

1. Establishment

Article 15 of the new law provides that a banking institution may be formed with partial or full foreign ownership and that branches of foreign banking institutions may be opened in Hungary for the first time.\textsuperscript{160} Furthermore, “a banking insti-

\textsuperscript{157} Id. at 416-17.
\textsuperscript{158} Act No. LXIX of 1991 on Banks and Banking Activity, pmbl., translated in 2 Hungarian Rules of Law in Force at 1779.
\textsuperscript{159} Hungary's New Banking Law, supra note 8.
\textsuperscript{160} Act No. LXIX of 1991 on Banks and Banking Activity, art. 15(1), translat-
stitution may be established in full or in part by a foreigner . . . on the condition that the foreigner" meets certain business requirements, and places a certain amount of capital in a Hungarian bank.\textsuperscript{161} The directors of any bank (foreign or domestic) must also prove to be versed in both the Hungarian language and the Banking Law before establishment will be authorized.\textsuperscript{162} These language and culture requirements are most likely derivatives of nationalist tendencies and Hungary's desire to protect the Hungarian language and values. If a foreign banking institution does not want to set up an incorporated office in Hungary, Chapter IX of the law allows foreign banking institutions to "set up long term bank representations" (i.e., branch offices) in Hungary by following the additional requirements of Article 15 for foreign authorizations.\textsuperscript{163}

2. Country of Regulation

Hungary's new banking law requires complete host state control in its regulation of both foreign and domestic banks.\textsuperscript{164} The 1991 law states that any banking institution offering its services in Hungary, whether incorporated inside or outside of Hungary, must be governed by Hungarian law, again fortifying the nationalist tendencies of the Hungarian governments.\textsuperscript{165} Therefore, if a foreign entity establishes a banking institution in Hungary, that foreigner's home state can have no further control over its banking activities, nor can it authorize the bank to engage in activities inconsistent with Hungarian law.

\textsuperscript{161} Id. art. 15(3)(a)-(d), translated in 2 Hungarian Rules of Law in Force at 1791-92.

\textsuperscript{162} Id. art. 15(4)(a)-(c), translated in 2 Hungarian Rules of Law in Force at 92. The directors must also promise to train Hungarian employees in competitive banking systems, showing the Hungarian government's desire to reverse the stagnation effect in their labor pool left from the Soviet regime.

\textsuperscript{163} Id. art. 83(1), translated in 2 Hungarian Rules of Law in Force at 1829; see also supra text accompanying note 161 for a list of the additional requirements for a foreign banking institution.

\textsuperscript{164} Id. art. 15(7), translated in 2 Hungarian Rules of Law in Force at 1792-93.

\textsuperscript{165} Id. art. 83, translated in 2 Hungarian Rules of Law in Force at 1829 (foreign investors are also subject to Hungarian law).
3. Minimum Requirements

Article 15 of the new Hungarian banking law also establishes the minimum requirements for authorization of foreign or domestic banks. A bank must have paid-in-capital of its own funds of five million forints before it can be authorized. Furthermore, the bank must maintain a solvency ratio of eight percent or higher at all times, or the bank’s charter will be revoked. These minimum requirements ensure that a bank is adequately capitalized to cover loans and deposits of the customers in cases of default, a safeguard similar to self-insurance by banks of customer deposits. These provisions are part of the effort to foster confidence in the Hungarian banking industry for both Hungarians and foreigners alike.

4. Foreign Treatment

The new Hungarian banking law requires that its banks abroad be treated with “identical” national treatment. Specifically, Article 15 provides that before a foreigner’s licensing request will be granted, the Banking Supervisory Body (BSB) in Hungary must first verify that a similar Hungarian bank, set up in that bank’s home nation, will receive treatment at least as favorable as the type of treatment which Hungary affords foreign banks. This provision assures Hungarian banks that they will have at least equal opportunities to merge into the international financial services community.

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166. Id. art. 8(4)(a), translated in 2 Hungarian Rules of Law in Force at 1788.


171. Id.
5. Ownership

Hungary's new banking law retains several important restrictions on the ownership of Hungarian banks. Article 18 of the law states that "[t]he proportion of direct or indirect shares for each owner of the subscribed capital . . . must not exceed twenty-five percent."\textsuperscript{172} This provision prohibits both foreign and domestic owners of any banking institution from owning more than twenty-five percent of any banking institution. In one small liberalization, Article 18 exempts banking institutions who effectuate merger transactions in Hungary from this twenty-five percent limitation, thereby allowing banks (and no other type of business venture) to purchase one hundred percent of the stock in an existing Hungarian bank.\textsuperscript{173}

Article 15 further limits ownership possibilities by providing that "a foreign person may hold interest in banking institutions incorporated in Hungary . . . unless the total foreign interests exceed ten percent of the subscribed capital of the banking institution."\textsuperscript{174} While the 1991 law allows foreigners to own parts of banking institutions in Hungary, a foreigner seeking to acquire more than ten percent of a pre-existing Hungarian institution must apply for permission from the NBH. Furthermore, before the NBH grants its approval, it must present its findings to the BSB in order to qualify for full official authorization.\textsuperscript{175} Because possible discrimination against foreign involvement may stem from Hungarian fears of foreign power over the economy and politics, foreigners seeking to acquire more than ten percent of a Hungarian banking institution may be thwarted by arbitrary official decision making.

\textsuperscript{172} Id. art. 18(1), translated in 2 Hungarian Rules of Law in Force at 1794. The purpose of this limitation was to reduce the NBH’s virtual monopoly control in the commercial banks in Hungary. Therefore by 1994, NBH must not hold more than 25% of any of Hungary’s banks. See supra note 93 regarding the holdings of the NBH in 1991.

\textsuperscript{173} Act No. LXIX of 1991 on Banks and Banking Activity, art. 18(1), translated in 2 Hungarian Rules of Law in Force at 1794.

\textsuperscript{174} Id. art. 15(1), translated in 2 Hungarian Rules of Law in Force at 1791-92.

\textsuperscript{175} Id. art. 15(4)-(6), translated in 2 Hungarian Rules of Law in Force at 1792.
6. Authorized Banking Activities

Finally, the new banking law retains many important limitations on the types of activities in which Hungarian banks may engage. Article 33 prohibits banks from engaging in the management of investment funds, and severely restricts banks if they try to undertake insurance activities, engage in securities transactions, or partake of certain commercial transactions. This provision absolutely precludes the use of universal banking which is widely authorized throughout most of the EC, and a key provision of the Second Banking Directive.


The EC's Second Banking Directive was passed in order to eliminate the various barriers to interstate banking within the EC. The provisions are aimed both at liberating the restrictions to interstate banking, and at setting clear minimum standards for the establishment of banks resulting in better customer protections within the EC. Any remaining restrictions appear to be aimed not at restricting intra-EC banking, but rather as leverage to force non-EC states to open up their financial services markets to EC banks. After all, the EC states wanted to ensure true regulatory liberation in the financial services market.

1. Establishment

The EC's Second Banking Directive addresses the issue of bank establishment by permitting a license acquired in any member state to be valid throughout the entire EC. Further explanation and references are provided for more detailed understanding.
thermore, the EC has addressed a major shortcoming of the First Banking Directive, which only liberated the establish-
ment provisions for EC nationals, by now allowing both EC members and non-EC members to utilize the "single passport" to establish banking institutions throughout the EC simply by acquiring a single license in one country. This version of the "single passport" liberates cross-border financing and allows the EC nations to become more interdependent while integrating them into the global economy as well.

2. Country of Regulation

The Second Banking Directive's regulation scheme introduces the concept of "home state" lawmaking. Article 13 pro-
vides that the laws of the member state in which the license is established, i.e., the bank's home, will constitute the essential regulations that govern the banking institution in all EC states. This version of the "home state" regulation differs from that of the First Directive, which allowed host states to fully regulate all the activities of a bank inside its borders. Moreover, under the Second Directive, all member states must now allow certain "core activities" to be pursued in their countries, even if their particular licenses do not authorize them.

Since one of the goals of the Second Directive was to curb forum shopping, "home state" regulations had to prohibit

185. Id. art. 13(1); see also Kessler, supra note 9, at 401.
186. See First Banking Directive, supra note 123, art. 3.
187. The core activities are accepting deposits from the public, lending, financial leasing, money transmission services, issuing means of payment (credit cards, traveler's checks, and banker's drafts), guarantees, trading for their own account or for customer accounts (in money market instruments, foreign exchange, financial futures and options, exchange and interest rate instruments, transferable securities), participating in share issues, advising on capital structures and industrial strategy, money brokering, portfolio management and advice, safekeeping and administration of securities, credit reference services, safe custody services, and consumer, mortgage, or commercial credit transactions. See Second Banking Directive, supra note 124, annex.
188. See discussion of the Annex of core activities which must be permitted in every EC member state, even if the state opts to limit its license to certain activities, infra subpart IV.B.6.
189. See supra text accompanying note 129 discussing the forum shopping permitted under the First Directive.
banks from seeking out the least intrusive regulations by only allowing a bank to take advantage of the core authorized activities list if that bank would be allowed to offer those banking services in its own country. Thus, "home state" regulation became the most important deterrent to forum shopping.

3. Minimum Standards

The Second Banking Directive, in combination with other new banking directives, specifies minimum financial standards before an institution can be licensed to conduct banking activity in the EC. Specifically, Article 10(1) of the Second Banking Directive requires that all EC banks maintain minimum capital reserves of five million ECUs. Furthermore, the Solvency Directive requires at least an eight percent solvency ratio, defined by the Directive as the ratio of assets to credit risks as a percentage, for all credit institutions who wish

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190. Second Banking Directive, supra note 124, recitals 4, 5. For example, in country A, savings banks are not allowed to underwrite securities transactions, but in country B there are no limitations on the scope of activities in which a banking institution can engage. Bank A may receive its single EC banking license in country A which will enable it to provide services freely throughout the EC, however, the license will be limited to activities which the bank would be able to engage in at home (i.e., it will not include a license to underwrite securities transactions even when it is doing business in the more liberal country B). However, a banking institution licensed in country B will be able to underwrite securities transactions even in the more strictly regulated country A with its single passport. Therefore, so long as (1) the EC license permits the activity, (2) the bank's home state permits the activity, and (3) the activity is on the list of acceptable activities in the directive, the activity may be pursued freely anywhere in the market. Id. recitals 4, 5, annex I.


to be licensed in the EC.\textsuperscript{193} The solvency ratio must be maintained at all times, under penalty of a bank losing its EC authorization.\textsuperscript{194} These provisions seek to inspire worldwide confidence in all EC banks, regardless of their nationality.

4. Foreign Treatment

The Second Banking Directive requires that non-EC nations offer EC banks reciprocal treatment.\textsuperscript{195} If read narrowly, this would require all non-EC nations to model their banking regulations specifically after the EC to have mirror image reciprocity.\textsuperscript{196} However, the requirement has recently been given a less restrictive reading to mean that EC institutions must be provided with "effective access" to the foreign market on a non-discriminatory basis.\textsuperscript{197} Still, if the Community decides that an EC institution has not been granted non-discriminatory treatment in a non-member country, the Community may suspend, either temporarily or permanently, the licenses of all of that country's national banks in the EC until negotiations can ensure proper treatment for the EC banks abroad.\textsuperscript{198}

5. Ownership

Noticeably, there are no limitations on ownership in the EC's banking directives.\textsuperscript{199} This has generally been the case throughout the EC because neither the First Directive, nor the various national laws of the member states, limited in any way the amount of ownership by foreign or domestic banks doing

\begin{itemize}
\item \textsuperscript{193} Solvency Directive, supra note 138.
\item \textsuperscript{194} Id. The Directive states that by January 1, 1993, all credit institutions shall be required permanently to maintain the ratio of at least eight percent. Id. art. 10(1). Furthermore, if the ratio falls below eight percent, the competent authorities may take over supervision of the bank until it returns to the requirement. Id. art. 10(3).
\item \textsuperscript{196} Goldstein, supra note 110, at 228-29.
\item \textsuperscript{197} Second Banking Directive, supra note 124, art. 9(3); Goldstein, supra note 110, at 228-29; Hymas, supra note 125, at 1687; Toll, supra note 113, at 626-28.
\item \textsuperscript{198} Second Banking Directive, supra note 124, art. 9(4).
\item \textsuperscript{199} See infra text accompanying note 248.
\end{itemize}
business in their countries. The EC has been fairly liberal in its ownership laws, and because most EC economies are already competition based, there is no need to limit ownership to increase competition between domestic and foreign banks.

6. Authorized Activities

Finally, the EC has very few prohibitions on the types of banking activities which may be practiced throughout the Community. The Annex to the Second Directive lists a large non-exhaustive list of permitted banking activities including the acceptance of deposits, lending, financial leasing, the issuance of means of payment, trading in securities, foreign exchange, and portfolio management. All EC members must permit foreign banks to engage in these activities within their borders, but the Directive does allow home nation licenses to limit these activities of individual national banks. The Second Directive therefore authorizes universal banking, but does not require every country to offer the same license. Banks are authorized to engage in a particular activity if: (1) the financial service to be provided is listed on the annex, and 2) the home member license of that bank permits the particular activity.

201. Second Banking Directive, supra note 124, art. 18.
202. Id., annex.
204. Worth, supra note 169, at 140 n.36; see supra note 26 (defining universal banking).
205. Second Banking Directive, supra note 124, recitals 4, 5. See also Gruson & Nikowitz, supra note 131, at 214; Gruson & Fuering, supra note 181, at 4; Schneider, supra note 115, at 271.

During the hearings regarding the single passport license, Manuel H. Johnson, the vice chairman of the Federal Reserve Board testified that the goal of these provisions was to create pressures within the Community for liberalization of more restrictive regulations, which would in effect create a Community with one standard for banking—the universal model. Oversight Hearings on EC 1992 Program: Hearings Before the Subcommittee on Financial Institution on Supervision, Regulations, and Insurance of the House Committee on Banking and Urban Affairs, 101st Cong., 1st Sess. 4-7 (1988).
C. Analysis

A comparative analysis of the Hungarian and EC banking laws establishes that although the 1991 Hungarian law meets some of the more basic regulations of Western style banking,\(^\text{206}\) many severe disincentives to foreign investment remain in the new Hungarian law.\(^\text{207}\) However, Hungary is not alone among modern economies in that others also maintain restrictive banking regulations.\(^\text{208}\) The purpose behind these strict regulations is primarily to protect banks from exposure to foreign dominance and overly exuberant risk takers.\(^\text{209}\) The countries with restrictive banking systems responded with dismay at the EC's banking industry liberalization because they were concerned that the EC's provisions—especially the Single Passport and universal banking provisions—would either pressure non-EC countries to enact similar legislation, or to forego their competitive presence in the newly liberalized market.\(^\text{210}\) If the Hungarian banking law fails to address each issue as did the Second Banking Directive, Hungarians may be foreclosed from the EC market, and Hungary's foray into the international community may be halted before it truly begins. However, the Hungarian banks are still in their developing stage and any additional economic pressure on them promises only to make a bad economic situation worse.

\(^{206}\) See infra subpart IV.C.3 (minimum standards).

\(^{207}\) See infra subpart IV.C.1 (establishment); subpart IV.C.2 (country of regulation); subpart IV.C.4 (foreign treatment); subpart IV.C.5 (ownership limitations); and subpart IV.C.6 (authorized activities).

\(^{208}\) For example, both the United States and Japan maintain tight control over the activities of both nationally regulated banks and purely local financial enterprises although even Japan is changing its restrictive nature. See generally Peter J. Ferrara, The Regulatory Separation of Banking From Securities and Commerce in the Modern Financial Marketplace, 33 ARIZ. L. REV. 583, 613 (1991).


\(^{210}\) Toll, supra note 113, at 626. Toll argues that the United States has not acted with much foresight in allowing the EC to lead the world in deregulation, and he predicts that this will most likely lead to serious harm of United States interests abroad. Id. at 617. Furthermore, other authors argue that "whatever emerges [in the United States, it] must deal with the weaknesses in the current system, and enable United States institutions to compete more effectively with their foreign rivals." Boger, supra note 152, at 1003.
Before comparing the actual banking provisions of the EC and Hungary, it is critical to remember that the business and political climates in the two countries are light years apart. Differing psychological philosophies and economic goals have reigned for the last forty years, which make most of the differences at least understandable. While the EC has been banking with the advanced ideals of the "single market"\textsuperscript{211} and "Freedom of Establishment,"\textsuperscript{212} Hungary has been struggling to gain merely small victories in the privatization of its market\textsuperscript{213} and the restructuring of its banking system.\textsuperscript{214} Furthermore, while the EC members have been players in the international marketplace of competitive banking, Hungary remains almost paralyzed by its fear of foreign economic and political domination.\textsuperscript{215} Finally, the EC is a world economic superpower, while Hungary fights to escape the remnants of an underdeveloped command economy. Thus, the financial growth of Hungarian banking will be advanced only through conservative fiscal policies and economic stability. Therefore, although Hungary is in grave need of foreign investment to aid in the transition to a market economy, she cannot tolerate too violent a change. Furthermore, because Hungarians are still mentally opposed to any foreign involvement in their economy, the laws have remained quite nationalistic to protect themselves from the evils of foreign involvement in their economy.

1. Establishment

One way in which the banking provisions in Hungary and in the EC differ lies in the ease by which a bank can establish a new branch. The establishment requirements in Hungary are much more restrictive than the corresponding provisions under

\textsuperscript{211} Wegen, \textit{supra} note 4, at S99.
\textsuperscript{212} EEC \textit{TREATY}, art. 52.
\textsuperscript{213} See Ash, \textit{supra} note 96; Patience, \textit{supra} note 96; Sloan, \textit{supra} note 19, at 78. For example, Sony Music Entertainment had been working in Hungary since the mid-1980s with a formerly state-owned monopoly through a licensing agreement. In March of 1993, Sony was finally able to privatize and incorporate fully in Hungary. This is a very small step, which hopes to pave the way for further foreign investment in the entertainment and music field, but it took over eight years to accomplish. See Kasriel, \textit{supra} note 96.
\textsuperscript{214} \textit{Hungary's New Banking Law}, \textit{supra} note 8; \textit{Riding the Tiger}, \textit{supra} note 8.
\textsuperscript{215} See \textit{supra} note 19 and accompanying text.
the EC regulations. In Hungary, the establishment of banks has been greatly liberated by Article 15, because for the first time a fully foreign bank can be established with little or no involvement of the NBH.216 However, if any bank (foreign or domestic) wants to set up a branch office in another part of Hungary, the bank must start from scratch and it cannot just use the first authorization to bank freely throughout the country.217 By contrast, the EC's Second Banking Directive liberates banking not only in individual countries,218 but throughout the entire EC. By authorizing member states to grant, and banks to receive, a single license in one of twelve countries, the Directive permits free expansion throughout the Community without any additional requirements.219

Establishing a bank in Hungary is a long bureaucratic process which must be endured each time a new banking institution is put in place, regardless of whether it is a branch office or a new incorporated office. This highly burdensome process obviously discourages foreign investors looking to open banks abroad from investing in the Hungarian banking market. Comparatively, the ease of establishment available in the EC has been not only a competitive advantage for EC banks, but may also have caused EC banks to be hesitant to establish institutions in more restrictive systems.220 The EC views such limited establishment rights as characteristic of more restric-

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217. Id. arts. 82-85, translated in 2 Hungarian Rules of Law in Force at 1829.
218. This was the effect of the First Banking Directive, supra note 123, arts. 3(2)-3(3). See supra notes 126-127 and accompanying text discussing the establishment clause in the First Banking Directive.
220. The United States is an example of a more restrictive banking system. Specifically, the United States has a dual system of banking regulation, whereby nationally chartered banks are regulated by federal laws, and state chartered banks are regulated by state laws and certain uniform national laws. See generally Wilmarth, supra note 151, at 969-77. Once a bank is established, the McFadden Act, ch. 191 § 7, 44 Stat. 1228 (1927) (codified as amended at 12 U.S.C. § 36 (1988)), and the Douglas Amendment, ch. 240 § 3(d), 70 Stat. 134 (1956) (codified as amended at 12 U.S.C. § 1842(d) (1988)), limit the ability of that bank to branch within the state or outside of that state by subjecting it to the provisions of the home state's laws. See Wilmarth, supra note 151, at 975-77. When an EC bank tries to branch throughout the United States, it is slowed to a halt with the extra legislation, which may have reduced the number of EC bank establishments in the United States.
tive banking systems, like Hungary's, as a competitive barrier for its banks abroad, and a great disincentive for EC banks looking to expand globally. The EC also asserts that it is unjust for foreign banks to come to Europe and expect the expansive establishment rights without the existence of similar incentives for EC banks abroad. Thus, because Hungary's limited establishment rights will substantially discourage EC investment in the Hungarian banking industry, the establishment provisions fail to meet one of the main goals of the 1991 law.

Arguably, the reluctance of EC banks to invest in Hungary may be due to Hungary's lack of market-oriented incentives characteristic of more financially stable countries rather than its restrictive bank establishment rights. After all, on occasion, restrictive banking regulations in other nations have not in fact discouraged foreign investment in these countries. However, there is no impetus for foreign banks to overcome the restrictive regulations in Hungary because there are very few foreign companies in Hungary who need financial backing from their home nation's banks. Furthermore, foreign banks would probably be viewed with suspicion by Hungarian business owners who are likely to deny a foreign bank Hungarian business in favor of a national bank. Moreover, Hungary is barely a competitive economy, and cannot begin to compete with the


For example, some in the United States fear that EC banks looking to branch out internationally will not want to establish in the United States due to the overly restrictive regulations. Boger, supra note 152, at 1021. Furthermore, the more liberal regulations of foreign banks have placed the United States banking industry at a competitive disadvantage. Wilmarth, supra note 151, at 964. As a result of this, many United States local and state governments have been reducing their regulations to permit more interstate banking because they recognize that the increased pressure from international banks is slowly reducing the competitive edge United States banks used to have over the world market. Id. Many have argued that if the United States hopes to survive the international trend, it will have to deregulate and consolidate its banks to compete with international banks. Id. at 964-67.

222. Hymas, supra note 125, at 1701-03.

223. Nobody claims that the United States has discouraged international banking by any means despite its restrictive banking systems. For example, Crédit Lyonnais (a French bank) is actively involved in not only banking in the United States, but in business and commercial mergers as well, showing that strict regulations did not act as a disincentive to keep this large and internationally important foreign bank out of the United States. See Meredith Fisher, Upheaval at MGM, WASH. POST, July 26, 1993, at B3.
economic superpowers around the world, and banks have no real need to establish themselves in Hungary. The forces which encourage foreign banks to overcome the restrictions of other restrictive regulatory situations do not exist in Hungary, and therefore the overly restrictive establishment regulation of the Hungarian banking law will discourage foreign investment in the Hungarian banking market, slowing rather than accelerating Hungary's acceptance into the EC market.

2. Country of Regulation

Another factor considered by bankers when seeking to invest in a new country is the choice of law provisions of the host state. In Hungary, all banks, foreign or domestic, are governed by Hungarian law, and are thereby limited to the listed activities of Article 33.224 This provision is similar to the approach of the EC's First Banking Directive which allowed the law of the host state to supersede the laws of the bank's home state, thereby limiting banks to what the host state permitted.225 By contrast, the Second Directive adopts the "home state" control approach, whereby the law of the licensing or home state remains the law of the bank throughout the EC.226

Because the host state control in Hungary turns regulation over to the national government of Hungary, the choice-of-law provision in the Hungarian banking law is likely to have an anticompetitive effect on the banking industry, despite the stated goals of the 1991 Law.227 While it was hoped the law

225. First Banking Directive, supra note 123, art. 4.
226. See supra note 190 for the example given. In this case, a German bank will be able to perform its universal banking with its German-EC license freely throughout the EC, even throughout Greece, whose banks are limited to certain listed activities. However, a Greek bank's Greek-EC license will limit it to certain specified activities, even in the very liberal Germany.
227. Like Hungary, the United States banking regulations rely on "host" state control. Boger, supra note 152, at 1013. This gives regulatory power over foreign banks to the state of location, and to the United States federal government. Therefore, since the laws of each state are different, a bank trying to expand throughout the United States has to have different bank procedures in every single state. Because of this, the United States Congress has tried for the last few years to curtail the power of the individual states over banks in their municipalities because of the hindering affect it has on interstate competition for both for-
would encourage foreign investment, the law will likely discourage it by subjecting all banks to Hungarian regulation, and leaving very little discretion to the home state. Over-regulation in a national banking policy like Hungary’s is being questioned internationally by foreign banks, businesses, and governments. Hungary may be well advised to allow home state control to invite free market banking instead of central regulation. Again, when banks are looking to expand globally, they will not choose an overly regulated market, especially when they can choose from liberal banking laws at home or in other liberated systems. 228

3. Minimum Standards

Surprisingly, Hungary and the EC have two similar standards in their banking regulations. The minimum capitalization and solvency standards required for bank authorization in the two regulations mirror one another. Both the EC and Hungary require that a certain amount of paid-in capital accompany a bank application, and that these sums of money remain in the bank’s reserves at all times. 229 Furthermore, both the EC and Hungary require that the solvency ratio of all banks be maintained at eight percent. 230 The purpose of these minimum required standards is primarily to serve as a cushion or insurance fund to absorb any losses that may occur. 231 Therefore, both the EC and Hungary appear to have realized that in order to inspire confidence in their banking institutions on the part of depositors and to actually protect its investors, banks must maintain minimum amounts of available cash at all times. 232

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228. See supra note 153 for a discussion of the race to the bottom.
229. Act No. LXIX of 1991 on Banks and Banking Activity, art. 8(4)(a), translated in 2 Hungarian Rules of Law in Force at 1788; Second Banking Directive, supra note 124, art. 10(1).
232. Alford, supra note 167. In addition to these protections, in order to en-
Interestingly, the levels of capitalization required by the new Hungarian law are precisely those levels which are required not only by the EC, but also by various international organizations. This development in Hungary reflects Hungary's intent to meet world-wide standards for the first time. The ability of Hungary's banks to meet these EC standards immediately will likely encourage further negotiations regarding Hungary's associate member status in the EC. Moreover, these provisions display the Hungarian government's active policy in favor of maintaining conservative, stable banks and enabling free competition without government intervention. The higher levels of capitalization ensure consumer confidence without requiring government protection, and are likely to increase foreign interest in investing in Hungary, without the fear of a reversion to government subsidization.

4. Foreign Treatment

The Hungarian banking law does not offer national treatment for foreigners attempting to invest in the financial services market in Hungary. By contrast, the EC's Second Banking Directive applies non-discriminatorily to both EC and non-EC members, thereby offering national treatment to foreigners in the EC. Furthermore, Hungary merely requires its banks to be treated to national treatment by foreign laws, while the EC's Second Banking Directive states that technically, the EC will demand "reciprocal" treatment (requiring the application of laws equivalent to the EC's Second Banking
Directive) for its banks abroad. In other words, EC banks expect to receive all the benefits of the EC banking law when they open offices abroad, and if they do not, the Community has the authority to refuse to authorize the establishment of that nation's foreign bank offices in the EC. Hungary only expects its nationals to be granted the same treatment by a foreign government as nationals of that foreign country.

Clearly, Hungary and the EC differ in their positions on foreign treatment. Hungary may claim that the EC's reciprocity requirement constitutes a "club in the closet," forcing Hungary's more restrictive banking regulations to conform with the EC's by threatening foreclosure from the EC market. Moreover, EC member states may be angry that Hungary will be permitted to become a "free rider" by enjoying the liberal access provisions in the EC while severely restricting access to the Hungarian banking market for EC investors.

236. Act No. LXIX of 1991 on Banks and Banking Activity, art. 15(4)(d), translated in 2 Hungarian Rules of Law in Force at 1792. Hungary expects its banks locating abroad to be subject to either Hungarian law provisions or the national laws of that country despite the fact that Hungary discriminates against foreigners. Cf. Second Banking Directive, supra note 124. EC banks wish to operate under the elements of the arguably liberal Second Banking Directive, even when they are banking in the more restrictive United States or Hungary.

237. Act No. LXIX on Banks and Banking Activity, art. 15(4)(d), translated in 2 Hungarian Rules of Law in Force at 1792.

238. Like Hungary, United States banks only require "national" treatment for their banks abroad, and only offer it to foreign banks in the United States. Hymas, supra note 125, at 1694. Foreign banks are treated to the same over-regulation with which United States banks must contend. When the EC's reciprocity requirement was first announced, United States bankers called the reciprocity requirement "a club in the closet" allowing the EC to force the United States to change its banking regulations to mirror the EC's regulations, or risk losing permission to bank in the EC. Id.; see also Goldstein, supra note 110, at 190 (discussing the United States fears that reciprocity would cause the United States to lose all international opportunities in the EC); see infra note 239 (discussing of the compromise settlement which the United States gained from the EC, again without changing any United States legislation).

239. During the United States-EC controversy, the EC was angry that the United States felt they had a right to complain since, as written, the Directive allowed the United States to be a "free rider," with United States banks reaping all the benefits of the EC's laws without giving any concessions in return. Many benefits of financial integration in the EC were soon to be granted to United States banks without any corresponding benefit in the United States' highly restrictive banking market. Hymas, supra note 125, at 1703. This controversy and anger over the reciprocity provision was so strong that EC leaders revised the requirement "in response to international criticism" to mean that non-discriminatory national treatment would be considered valid foreign treatment. Id. at 1693;
Because of this disparity of treatment, it is likely that Hungarian banks will be denied EC licenses until and unless the Hungarian law at least offers non-discriminatory national treatment. For example, a non-Hungarian who wishes to establish a bank in Hungary must fulfill eight separate criteria which must be reviewed by the NBH and the BSB, \[240\] while a Hungarian national is presumed to have fulfilled the requirements, and will be authorized upon the mere notification of the BSB. \[241\] Furthermore, a Hungarian may purchase up to twenty-five percent of any banking institution without question, \[242\] while a foreigner is subject to scrutiny at a ten percent purchase level. \[243\] This policy again most likely emanates from the severe xenophobia on the part of Hungarians, which causes them to set up ethnic and national barriers around all types of commercial laws. \[244\]

These discriminatory provisions discourage foreign investment in Hungary because foreigners are not afforded the same treatment as Hungarian nationals, and therefore, "national treatment" is not fulfilled. Furthermore, it is very likely that the EC could impose the higher reciprocity standard in its evaluation of Hungary in retaliation for its discriminatory practices. \[245\] The favorable economic and political conditions

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Rockwell, *supra* note 195. EC officials wanted to be certain that United States banks did not get too angry at their perceived problems with the Directive, because the EC “has everything to gain from a real single market in financial services that is open to the world.” Keith M. Rockwell, *EC Banking Market to be Open to World Commissioner Says*, J. COM., May 1, 1989, at 7A, available in LEXIS, NEXIS Library, JOC File. Thus, the EC does not intend to close the doors to foreign banks unless there is discrimination in the foreign markets. *Id.* This means that any nation which treats foreign banks the same as its national banks shall receive EC benefits. Hymas, *supra* note 125, at 1683-94.


241. The only limitations to a Hungarian is that he or she have no police record, have a college degree, and have some management experience. Act No. LXIX of 1991 on Banks and Banking Activity, arts. 12-14, translated in 2 Hungarian Rules of Law in Force at 1790-1791.

242. *Id.* art. 16(1), translated in 2 Hungarian Rules of Law in Force at 1794.

243. *Id.* art. 15(1), translated in 2 Hungarian Rules of Law in Force at 1791-1792.

244. *See supra* note 19.

245. Second Banking Directive, *supra* note 124, art. 9(4). *See generally* Gruson & Nikowitz, *supra* note 131, at 229-40 (discussing the various applications of the reciprocity requirement); Toll, *supra* note 113, at 626-27. The test is probably a flexible one, but it has retained some bite for discriminatory practices. Goldstein,
which encourage the EC to be more lenient on some other legislatively restrictive nations do not exist in the Hungarian situation. The Hungarian market desperately needs an infusion of advanced systems and European support, while the EC will lose nothing from foregoing the new banking opportunities in Hungary. The EC has nothing to gain by being lenient on Hungary, while Hungary has everything to gain by being open to the EC—it gains market access now, and earlier membership status in the future. Hungary's failure to offer national treatment will therefore slow full membership talks with the EC and will discourage foreign investment in Hungary.

5. Ownership

An additional distinction between the banking law in Hungary and that of the EC lies in their ownership requirements. The new Hungarian banking law provides strict limitations on the ownership of banks. Specifically, no one party, foreign or domestic, can own more than twenty-five percent of the outstanding capital in a Hungarian bank, unless that party is another banking institution.246 Furthermore, if a foreigner tries to acquire more than ten percent of a Hungarian bank, the foreigner must seek the permission of the BSB.247 In stark contrast, the EC has placed no limitations on the percentages which can be owned by any one party in any type of bank.248

The primary reason for the Hungarian limitation is to advance the privatization and decentralization of the banking system.249 Before 1987, all of the banks in Hungary were owned and operated by the government.250 The overly centralized power base has not only slowed the reform efforts,251 but has probably allowed a certain amount of centralized planning to remain in the banking system.252 In order to cut down

supra note 110, at 229-30; Rockwell, supra note 239, at 7A.
246. Act No. LXIX of 1991 on Banks and Banking Activity, art. 18(1), translated in 2 Hungarian Rules of Law in Force at 1794.
247. Id. art. 15(5), translated in 2 Hungarian Rules of Law in Force at 1792.
248. See generally supra notes 199-200 and accompanying text.
249. Lock et al., supra note 8.
250. See supra note 93.
251. See Hall, supra note 155, at 221.
252. For example, in France where the banks are undergoing continuous deregulation and denationalization, the government acknowledges its continuing power
on the NBH's power to encourage further decentralization and further reforms, the 1991 law makes it illegal to own above a specified amount of a Hungarian bank.\textsuperscript{253} By contrast, because most of the European banking systems have been primarily competitive-based and historically privately-owned, they do not need decentralization laws or ownership caps.\textsuperscript{254} On the other hand, those EC members who are still in the process of deregulating their purely government-controlled economies are expected to suffer greatly in the advent of the single banking market.\textsuperscript{255}

The Hungarian ownership limitations will encourage foreign investment in the banking sector, but not as much as the Hungarian legislature may have hoped. It will encourage foreigners to invest in Hungary because many shares of Hungarian banks will go on sale on the international market for the first time. However, at the same time, it will discourage investment, because foreign parties who wish to invest will want to do so from a position of power. If a party is limited to purchasing ten to twenty-five percent of a bank, it will have less power to control the actions of that bank. Furthermore, it may be seen that by limiting ownership, Hungary is limiting the ability of foreigners with banking experience from effectively changing the course of a bank. Thus, under the new Hungarian regulations, the foreigner will not invest given the minimal opportunity to control banks from a small ownership position with relatively little power.

6. Authorized Activities

The last critical difference between the Second Banking Directive and the new Hungarian banking law is the list of authorized activities permitted under each regulation. Hungary to pressure private banks' activity by setting interest rates and monetary policy according to the government goals. Id. at 210-11.

253. As of October 20, 1993, the NBH has conformed with this provision in all but one bank, and now owns twenty-five percent or less of all the banks. Government to Discuss Proposals on Central Bank, MTI ECONONEWS, Oct. 20, 1993, available in LEXIS, NEXIS Library, MTI File.

254. Kessler, supra note 9, at 414-17 (explaining weakness of former government owned institutions as compared with competitive banks).

255. See supra notes 155-157 and accompanying text (discussing the current problems for the historically overly regulated and government owned Spanish, French, Italian, Portuguese and Greek banks).
only allows banks, foreign or domestic, to engage in very basic financial services, and absolutely forbids its banks to engage in investment, insurance, or securities activities. By stark contrast, the EC Second Banking Directive permits universal banking, meaning that almost any activity involving the supply, control, or use of financing is valid so long as the license received by the home state permits it. Article 33 of Hungary's 1991 law is similar to article 4 of the EC's First Banking Directive which did not mutually recognize banking licenses and thereby limited the banking activities which could be practiced in that nation, regardless of what the bank's home state laws allowed.

The decentralization of money and expertise under limited two-tiered systems such as Hungary's create several problems such as increased inefficiencies in the home market as well as decreased competitive advantages in foreign markets.


257. Id. art. 33, translated in 2 Hungarian Rules of Law in Force at 1801-1802. This description is generally known as the dual-tiered system, forbidding the commingling of commercial and investment banking. More, supra note 209, at 434.

258. Second Banking Directive, supra note 124, art. 18, annex; see supra note 26 for a definition of universal banking.

259. For example, if bank A gets a license in Greece, it will not be permitted to engage in insurance underwriting, even when it opens a branch office in Germany. However, bank B's German license will be mutually recognized by even the Greek authorities, and will thereby permit insurance underwriting in Greece.

260. First Banking Directive, supra note 123, art. 4. Both the First Banking Directive and the Hungarian methods limit the activities to the law of the host state. Bank B, a German bank located in Hungary (see supra note 259), will not be permitted to engage in insurance underwriting, just as it would have been forbidden from doing in Greece under the First Banking Directive.

261. This problem has been addressed recently in the analysis of the United States system, which is very similar to the current Hungarian system. Specifically the Glass-Steagall Act, ch. 66, 48 Stat. 162 (1937) (codified as amended in scattered sections of 12 U.S.C.), completely separates the functions of commercial banking from investment banking activities, and limits the activities in which either type of bank can engage. For example, in the United States, any bank authorized to take deposits cannot engage in or be affiliated with an institution which provides investment banking, and vice versa. Some have described the difference between universal banking and the more limited system as the difference between "buying a car and buying the parts separately to build the car." Boger, supra note 152, at 1024 (citing SUBCOMM. ON FINANCIAL INSTITUTIONS, FINANCE AND URBAN AFFAIRS, REPORT ON TASK FORCE ON THE INTERNATIONAL COMPETITIVENESS OF U.S. FINANCIAL INSTITUTIONS, 101st Cong., 2d Sess. 291-95 (Comm. Print 1990)). Furthermore, it is generally agreed that the distinction "inhibits
However, some commentators point out that while universal banking can be very effective in highly developed nations, it can be disastrous to less developed economies. The fear is that by allowing banks to engage in both commercial and in-

foreign competition without serving a valid domestic purpose" in the United States because the United States already has a competitive advantage in the trade of services, and has no need to protect its banking industry. Hymas, supra note 125, at 1688. It has traditionally been stated that the limitations in the United States banking field have put United States banks at a tremendous disadvantage when foreign corporations go looking in the United States for the same type of financial services that they can get overseas. Boger, supra note 152, at 1024.


263. Toll, supra note 113, at 635. The trend toward universal banking is expected to continue due to the competitive advantage this type of system offers for less restricted banks. Schneider, supra note 115, at 280. It has been stated "while the international community is playing soccer, we [the United States] continue to play United States football." Marylin B. Cane, The Eagle or the Ostrich: A United States Perspective on the Future of Transnational Banking, 25 VAND. J. TRANSNAT'L L. 183, 183 (1992). The United States Congress probably realizes this, and instead of repealing the law, every year, more loopholes in Glass-Steagall are found, allowing banks to do today what was unimaginable ten years ago. Id. at 200-01. Some commentators even argue that United States banks may not be contemplating significant expansion into the global market because in order to do so, the United States Congress must get rid of Glass-Steagall. Toll, supra note 113, at 640-41. Unless the United States Congress does repeal the restrictive laws, it cannot hope to see its banks maintain their current market share, especially in Europe. Id. at 642.

Even lesser developed economies are joining the banking trend of allowing universal banking. See Davis, supra note 262, at 107-08. Davis argues that Mexico's foray into the universal banking system will encourage more foreign investment in their banks, particularly in the commercial banking industry despite the considerable protection Mexican banks still receive. Id. at 107-08.

264. Interview with Roberta Karmel, Professor at Brooklyn Law School and Former Commissioner of the Securities and Exchange Commission, at Brooklyn Law School, Brooklyn, N.Y. (Jan. 27, 1994) [hereinafter Karmel Interview].
vestment transactions, banks will gain control over the entire securities market. Instead of creating an efficient competitive pricing market, allowing banks to engage in securities trading establishes a market which is centrally controlled by the large banks, creating a situation where one small fiscal mistake can become nationally disastrous. Furthermore, allowing banks to engage in significant securities activities may place the deposits at substantial risk at a time when the economy's lesser developed banking industry needs to be encouraging stability and conservative lending decisions. These commentators argue that any mass deregulation in the banking industry, to keep up with the less restrictive banking systems in an economy in transition, may therefore be very dangerous to the developing economy. Overextended bank capital and significant risk to deposits and investments may in turn lead to failed banks and government intervention. Thus, it may well be that Hungary's choice to defer universal banking was quite prudent in light of its need for economic and fiscal stability.

Still, Hungary currently hopes to speed up its acceptance into the EC, but cannot expect to be admitted while retaining such strict limitations on banking activities. Furthermore,

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265. Id.; see also More, supra note 209, at 441-42 (describing the pre-Glass-Steagall situation in the United States whereby the commercial banks dominated the securities markets and exposed themselves to inordinate amounts of risk, causing not only the 1929 stock market crash, but also too many bank failures to count).

266. Karmel Interview, supra note 264. When the United States was passing the Glass-Steagall Act, one of the most often mentioned reasons was that "the commercial banks shouldered a large share of the responsibility for the Depression because of the[ir] speculative securities activities." Macey, supra note 209, at 1291.

267. Id. at 1277. "The leading edge issue in banking law today is—or ought to be—bank risk. Every issue in banking law, whether it be bank failure policy, entry restrictions, geographic restrictions, . . . restrictions on the scope of bank activities, minimum capital requirements, or lending limits, was, at least ostensibly, promulgated in order to mitigate the problem of excessive risk-taking by banks." Id. at 1277 (emphasis added).

268. The race to the bottom theory is discussed at supra note 153.

269. Schneider, supra note 115, at 287. In fact, the three stated purposes for the limited two-tiered system (like Hungary's and the United States') are consumer protection, efficient credit distribution on a macroeconomic level, and effective monetary policy. Emeric Fischer, Banking and Insurance—Should Ever the Twain Meet?, 71 Neb. L. Rev. 739, 744 (1992).

270. See generally Visegrad, supra note 5; see also French Foreign Minister Backs Hungary's EC Membership Bid During Budapest Visit, BBC MONITORING SERVICE--E. EUROPE, June 15, 1993, available in WESTLAW, INT-NEWS-C File;
Hungary is trying to encourage foreigners with more competitive banking experience to infuse the Hungarian economy with market-based capital banking experience. Many commentators no longer agree that the limited system will actually protect consumers from bank failures, and that by limiting the banks options, the government leaves the bank open to reduced efficiency, and unable to counteract the effects of economic downturns. By limiting the activities in which banks can engage, Hungary’s 1991 law encourages banks with efficient universal systems to go elsewhere rather than risk the inefficient use of their knowledge and capital base in Hungary. Finally, if Hungary hopes to compete in Europe, she may have to offer the one-stop banking of the universal model, because she does not have the broad-based pre-existing market that other banks in the global field already have.

Hungary probably recognizes these negative attributes to restrictive banking, yet chose the limited system rather than the universal system in order to give Hungarian banks a chance to catch up to the high international banking standards. Universal banking could result in adverse effects in Hungary. For example, universal banking could spread the limited capital base and banking experience over too many activities. Thus, banks would likely overextend themselves in an effort to offer every conceivable service to their customers. Moreover, under universal banking, Hungarian banks would be more inclined to utilize the stock market and thereby place depositor’s investments in grave risk instead of focusing on prudent and conservative investments. By limiting authorized activities, Hungary is enforcing the conservative view that in order for Hungary’s banking system to be successful, the banks need to be slowly acclimated to the competitive system to avoid the problems of inefficient diversity, inefficient funding, and inefficient management which could come with a dramatic shift to universal banking. Hungarian banks should be-

Nisbet, supra note 95, at 1.

271. More, supra note 209, at 466. Several studies show that the 1929 United States stock market crash was not caused by banks engaging in securities activities. “[M]ost of these failures were due to structural weaknesses in the banking system, notably the prohibition of nationwide banking and a restrictive monetary policy.” Id. at 440-41.

come strong in basic banking activities first, and gradually be exposed to the more advanced forms of universal banking.

V. OBSERVATIONS AND IMPLICATIONS

Hungary unquestionably needs foreign investment in its banks to ensure the future success of its banking system. The economy at large and the financial industry have both recently stagnated in Hungary's slow forward progress into a true Western-style system. The bureaucrats in charge of this privatization process have no experience in the competitive banking model, and only know of the antiquated and inefficient Soviet model. Thus, any time the economic bureaucracy institutes a necessary reform, they speak of it as a radical alteration; however, in reality it is merely a necessary step to allow Hungary to catch up with the rest of the world. Moreover, Hungary is completely dependent on the international trade market for most of its primary products, and cannot merely shut its borders to foreign companies and banks. If Hungary's banking system were friendlier to foreign banks, the increased westernization would make foreign companies feel more comfortable trading goods and services in Hungary, and encourage them to make further investments in the Hungarian economy.

While Hungary appears cognizant of its need for foreign investment in the banking industry, there are several factors which continue to hinder its complete integration into the international community. Primarily, Hungary is being held back by its historically based paralyzing fear of foreign involvement in the economy. The banking law has thus remained very nationalistic, with discriminatory provisions to protect national banks while disadvantaging foreign banks. Although some of the recent liberalizations open the doors to foreign involvement on a large scale for the first time, the reforms place foreign investments under strict ownership limitations and require foreigners to meet higher criteria after extensive review processes. This provision alone places Hungary well below

that Rusznak of the state banks said that all the EC rules cannot be adopted at once, but that eventually Hungarian banks will go to universal banking. *Hungary's New Banking Law*, supra note 8.

273. See *supra* notes 20-21 and accompanying text.

274. See *supra* note 19 and accompanying text.

275. Act No. LXIX of 1991 on Banks and Banking Activity, arts. 15, 18, *trans-
the establishment provisions of the Second Banking Directive. However, Hungary's psychological reluctance can be understood by remembering that until recently, the NBH was the almost exclusive source of authority in the Hungarian banking industry, and is now decentralizing in favor of foreigners for the first time. The infusion of foreign investment in the banking industry will have to therefore take some time as Hungary actively overcomes its xenophobia.

Another factor hindering Hungary's economic transformation is time. It has taken the EC, an advanced economic organization, over forty years to drop their barriers and become a truly common market, yet Hungary has been expected to change its entire economic structure in six short years of economic crisis. It is extremely time consuming to transform a traditional Soviet-type economy into an efficiently operating market economy due to the lack of competitive spirit which Western economies prosper under. If such transformation is to take place, the process will take decades to complete, even if economic conditions are perfect. Since 1987, Hungary has dismantled a command economy monobank, set the commercial and retail banks free, required bank profitability, made steps toward technological advancements, and written laws which are modelled exactly after the EC's banking provisions and Western standards. In fact, the non-Hungarian discrimination provisions in Hungary's banking law strictly mirror the provisions of the First Banking Directive. Furthermore, Hungary has, by limiting foreign banks by Hungarian laws, done exactly what the EC's First Banking Directive did by limiting the scope of banking by the governance of the host state's banking law. It seems, therefore, that Hungary deserves

*lated in 2 Hungarian Rules of Law in Force at 1791-1793, 1794.
277. *See supra* note 93 and accompanying text.
278. *See supra* note 43 describing the Soviet-type economy which completely removes any profit seeking orientation from the running of a business. Competitive forces have not existed in Hungary for over forty years, thus not only does the government have to create competition, but the government must also teach its citizens how to work and profit in the competitive marketplace.
the same twenty years to advance to the EC level that it took the EC to make the necessary modifications to the First Banking Directive.282

One major question remaining is why the Hungarian Legislature did not merely return to the universal model effectively used in the early nineteenth century.283 The answer is two-fold; psychological avoidance, and economic impossibility. First, an examination of the psychological underpinnings of the Soviet-type economy displays how difficult it is for any reforms to actually take place. Hungary was under the Soviet regime for over two decades, and for the next two decades she was trying to remember how to maintain a truly market based economy. Now, Hungary is asked to totally reform not only its banking system and its economy, but its entire way of life. Moreover, one of the major difficulties of reform is that it must adversely affect the interests of the political bureaucracy, which derives substantial benefits from the administration and control of the economy. However, this same bureaucracy is required to do much of the work in implementing the reform and thus is being expected to cooperate in its own extinction.284 This inherent conflict in goals among the bureaucrats of the NBH makes it much easier to understand why the reforms take so long, and appear to be in such small steps.

Secondly, even if Hungary's Parliament wanted to return to universal banking in 1991, the economy was probably not stable enough or staffed adequately enough with Western trained bankers to return to that system, in light of the anti-competitive structure that it had been subjected to for over forty years under the Soviet system. It may be that Hungary could not risk offering such advancements as universal banking at this early stage. Hungary realized that if establishment and consolidation were made too easy, Hungarian banks could have become too large and inefficient.285 Once the bank be-

in 2 Hungarian Rules of Law in Force at 1829; First Banking Directive, supra note 123, art. 4.
282. For example, Hungary was able to meet the capitalization and adequacy standards because they have been around longer than any other EC banking laws.
283. See supra notes 26-28 and accompanying text.
284. Roger A. Clarke, Reform of Soviet-Type Economies: Lessons of Hungarian Experience, in SECOND DECADE OF ECONOMIC REFORM—PERSPECTIVES ON EASTERN EUROPE, supra note 56, at 167.
comes "too big to fail," the Hungarian government will be forced to rescue it despite its inefficiencies and poor customer service.\textsuperscript{286} What Hungary needs now is profit-seeking efficient banks, willing to work within the new competitive system, and capable of growing to accommodate universal banking gradually over time. The Hungarian economy cannot tolerate the havoc that would occur if the banks failed, and thus must remain conservative in the continuing transition to a fully market-based economy.\textsuperscript{287}

Moreover, Hungary is not yet a member of the EC, and universal banking may be better suited for a harmonized quasi-governmental system than for a single economy in transition. The EC must accommodate the wishes of each nation, because the country which feels slighted can block the adoption of the directive in its entirety.\textsuperscript{288} In order to accommodate all twelve member states, the universal system authorizes all banking activities, without requiring anything specific. However, the economy of Hungary is not ready for so many choices, and thus, by limiting establishment rights and the types of authorized banking, Hungary will be helping its own banks to catch up.

Finally, it is critical to remember that the EC and Hungary have differing resources, concerns, motives and goals at this point in each one's development. The EC is interested in maintaining its international competition with world economic leaders, and in using its comparative advantages to gain larger portions of current markets. In contrast, Hungary desires to create new stable trading relationships, while infusing its economy with efficiency in order to finance its structural reform. In terms of both economic and banking development, Hungary is at least twenty years behind the Western world, and it most likely needs this intermediate banking regulatory scheme to move conservatively to the next step of full modern banking regulation.

\textsuperscript{286} Id.
\textsuperscript{287} See supra text accompanying notes 155-57 (discussing the somewhat dismal future for banks in EC states which are unprepared for the liberal provisions of the Second Banking Directive).
\textsuperscript{288} See supra note 117 and accompanying text.
VI. CONCLUSION

Although Hungary's stated goals are to encourage foreign investment and to meet the necessary standards to become a full EC member quickly, the new banking law leaves many barriers to foreign investment in the banking industry, and falls short of EC standards. Hungary retains discriminatory provisions in the establishment clause of the 1991 Banking Law, which makes it more difficult and less desirable to invest in the Hungarian banking industry. Secondly, a bank which establishes itself in Hungary, even if it has liberal regulations at home, is severely limited by being subjected to Hungarian regulations, particularly in the area of authorized activities. Thirdly, although the new law meets international standards for minimum capitalization and solvency, the fact that Hungary does not offer at least national treatment for foreign banks remains an almost insurmountable barrier for foreigners looking to invest in the Hungarian financial services market. Additionally, the fact that the new law limits the percentage of stock which any particular owner can buy severely discourages foreign investors who may seek to purchase majority stakes in the Hungarian banks, but are precluded from doing so by the new law. Finally, the new law will discourage new investors from countries permitting universal banking from choosing to invest in Hungarian banks, because although the new law may be the only practical conservative approach for Hungary at this time, Hungary retains the often criticized dual-tiered restrictive structure.

In order for Hungary to encourage more investment and meet the standards under EC's Second Banking Directive, it will have to update the Banking Law with at least one more major reform. The reformed banking structure will have to: (1) allow foreign investors in the financial services market "effective access" to Hungary's banking market, without any discriminatory treatment regarding ownership percentages; (2) liberate the scope of activities in which banking institutions may participate in Hungary, to enable Hungarian banks to compete with the universal banking structure of the EC; and (3) maintain strict rules requiring banks to be profit-seeking, by forcing Hungarian banks to utilize rational business decisions for credit authorization, thereby making the banks stron-
ger and better able to compete. If a reformed law can meet these large-scale goals, Hungary's efforts to enter the global market in other areas of the economy will be greatly facilitated, and the Hungarians as a whole will substantially benefit.

Overall, Hungary must be applauded for her efforts to date. She has come farther than any other former Soviet-bloc nation, and in the banking industry, has done so in record time. Furthermore, Hungary has made these tough changes without help from the Western world and in spite of the world's suspicious view of former communist nations. Finally, the new Banking Law must be seen not as an end to Hungary's efforts to enter the global banking market, but merely as an excellent sign of things to come in the future for Hungarian banks and the overall Hungarian economy.

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