Agenda Item 2/a.
for the General Meeting
of April 12, 2005

REPORT

ON 2004 ACTIVITIES OF THE HUNGARIAN BANKING ASSOCIATION

BUDAPEST, MARCH 2005

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With an outstanding profitability by international standards and meeting all prudential criteria, the Hungarian banking sector in 2004 closed its most successful year ever. New products were introduced to the market and important technology development projects were implemented.

All these results were achieved in a controversial environment. Last year continued to be characterised by some unpredictability in monetary decisions and inconsistent monetary and fiscal policies in terms of both measures and communications. Largely due to this, real interests remained high, which helped increase interest margins in the short-term but may set back economic growth in the long-term.

Fiscal consolidation continued last year, a process strongly supported by the banking community. However, we continued to draw attention to the fact that consolidation is still unsatisfactory and the taxes burdening the business sector are still excessive.

A favourable development last year was the moderate increase in households' saving propensity; however, the rate of savings is still low, which, coupled with a relatively high budget deficit, has necessarily led to an unsustainable level of external current account deficit. Therefore, the banking industry joins those urging measures aimed at increasing households' savings propensity and, thereby, reducing budget deficit.

Bank's activities in 2004 were directly affected by

- changes in housing subsidies;
- the commencement of re-channelling and pre-financing of EU grants;
- continued preparations for the adoption of EU financial standards;

Invariably, the Association considered it a primary task to support banks in their preparations for implementation of the new EU Capital Requirements Directive, adoption of international accounting standards and tasks related to creating a single financial market in Europe. Our associates provided banks with regular information on activities performed in the European Banking Federation's working groups.

Participation in the work aimed at creating a Single European Payment Area (SEPA) continued to be a priority in 2004. Under the Payment System Forum, six new technical committees were set up, including a Technical Committee on the development of Cashless Payment Methods, a Cards Technical Committee, a Technical Committee on Cash Transport and Processing and the GIRO Technical Committee.

I. ASSOCIATION EVENTS

1. Hungarian-Russian Bankers' Conference

On May 26, 2004 Hungarian and Russian bankers held a conference in Budapest on the role commercial banks can play in promoting bilateral trade and production relations between the two countries.

The conference was addressed by the Prime Minister of Hungary. ***Peter Medgyessy*** welcomed the beginning of a dialogue as a good sign and said cooperation between the two countries should be restored. Cooperation between the two banking sectors means a new stage in confidence building. The Prime Minister said the government welcomes the strengthening of relations between the two banking sectors and banks operating in Hungary are willing to contribute to promoting economic relations between the two countries.

At the conference, organised under the sponsorship of the Minister of Economy, *Tamás Erdei*, President of the Hungarian Banking Association gave an overview of the Hungarian banking system, reviewing the status of credit institutions, their performance, development trends and challenges. Mr Erdei pointed out that the Hungarian Banking Association became a full member of the European Banking Federations at the beginning of 2004, preceding by a few months Hungary's accession to the EU; Hungary's banking sector is one of the best regulated in the region, with an up-to-date legal framework established in the first half of the '90s and a supervisory framework up to European standards.

Gennadij G. Melikjan, Deputy Chairman of the Central Bank of the Russian Federation pointed out that there is now economic and political demand for strengthening ties between Hungarian and Russian businesses and developing financial relations can provide a good basis for this.

Jurij I. Kormos, Vice-President of the Russian Banking Association presented his organisation and its activities. ***Andrej V. Lapko***, a Vice-President of Bank of Moscow presented their system of cooperation in the various Russian regions and pointed out that with its established contacts, Bank of Moscow's could efficiently contribute to promoting Hungarian businesses' endeavours in the CIS. ***Ferenc Karvalits***, CEO of CIB Central European International Bank, giving facts about the decline in financial relations and trade finance following the Russian crisis, reviewed those areas where CIB sees opportunities for cooperation. ***Margit Labancz***, Division Manager of Hungarian Foreign Trade Bank, the first bank to be privatised in Central and Eastern Europe, gave an overview of Hungarian Foreign Trade Bank's role in corporate lending and the bank's international activities.

The leaders of Eximbank and MEHIB Hungarian Export Credit Insurance Ltd. gave a summary of practical experiences in export lending and insurance. Views of the business sector were presented, inter alia, by the directors of Medicor, Transelektro and Rába.

2. FBE seminar for new and associate members on operations of the Banking Supervision Committee

At the recommendation of the FBE Secretariat, the FBE Banking Supervision Committee held its 51st Meeting in October in Budapest. By choosing Budapest as a venue for the meeting, the FBE wished to recognise the active participation of the Hungarian Banking Federation, initially as an

observer and, since this year, as a full-fledged member, in activities of the various committees and working groups of the FBE

In the afternoon of the day before the meeting a seminar was held for association representatives from the new EU member states and candidate countries. The seminar was attended by the banking associations of Bulgaria, the Czech Republic, Croatia, Hungary, Poland, Slovakia, Slovenia and Turkey. At the seminar, associates of the FBE gave presentations on the activities and services of the Banking Supervision Committee, on EU institutions, the Lamfalussy Process and the work performed within the Banking Supervision Committee, with special regard to the Committee's role in developing a European Capital Requirements Directive based on Basel II. In a roundtable, the new and candidate members presented their banking sectors and banking associations and the issues their key issues concerning the proposed new Capital Requirements Directive and their views of cooperation and division of responsibilities between home and host supervisors. The FBE requested new members to take up contact with their MEPs (or their assistants) and financial attachés in Brussels and familiarise them with professional issues and industry interests related to the Capital Requirements Directive.

The Hungarian member of the CEBS, István Farkas, President of the Hungarian Financial Supervisory Authority, was invited to the meeting of the Banking Supervision Committee. In his presentation, István Farkas spoke about the CEBS's tasks and priorities, its working method and proposed consultation practices, the CEBS's recommendations on outsourcing and the application of Pillar 2, and on cooperation difficulties within the CEBS. In his presentation and answers to questions Mr Farkas expressed his belief that for a uniform implementation of the new Capital Requirements Directive in the spirit of a single European market and for a successful application of the consolidated supervisory model, close cooperation between supervisors based on mutual confidence will be indispensable.

3. Meeting with the Interior Ministry's Deputy State Secretary responsible for crime prevention

At the Interior Ministry's request, András Hegedűs, the Deputy State Secretary responsible for crime prevention at the Ministry of Interior held a short meeting with the Association's Secretary General and staff members on March 12, 2004. At the meeting, brief information was provided on the status of the review of the concept for "the regulation on civil security and information gathering services and protection obligations". The main topic of the meeting was the possible contribution of banks to crime prevention. In the Interior Ministry's opinion, the reduction of cash payments has a very important role in combating crimes against property. The colleague responsible for payments systems at the Association gave a briefing on developments in promoting the use of smart cards and on preparations related to the proposed Act on electronic money.

4. Cooperation with the National Police Headquarters

At the initiative of the Bank Security Committee, the Hungarian Banking Association concluded an agreement with the National Police Headquarters to further improve bank security.

Sent to all member banks for information and implementation, the agreement is expected to enhance security in banking and to **improve the public image of banks**.

Under the agreement, a working committee made up of bank and police specialists was set up to develop proposals for setting up direct alarm systems and improving training in both areas.

5. Information Security Working Group

The Information Security Working Group was formed and held it first meeting on March 26, 2004, as an independent working group attached to the Bank Security Working Group of the Association's Bank Security Working Committee. (The Bank Security Working Group is charged with addressing issues related to the mechanical, physical, and human protection of financial institutions). The Information Security Working Group sets its own work plan and work schedule and meets as necessary, but at least bi-monthly. Members of the Working Group may regularly obtain information on new threats to IT systems and the latest development results in information technology, participate in the drafting, adoption and review of legislation and standards affecting information technology; develop information security recommendations for member banks, provide assistance in professional training and keep contact with fellow organisations performing similar tasks.

6. Professional conference at the Budapest Municipal Court

At the initiative of the Chairman of the Budapest Municipal Court, a conference programme was launched in cooperation with the Hungarian Banking Association. The first event under this program was on May 3 and 4 in the Jury Hall of the Budapest Municipality Court. The objective of the conference is for judges to know more about certain money and capital market transactions through acquiring first-hand information from financial specialists. Capital market institutions and transactions were the main topics of the two-day conference, with presentations offered by prominent banking and stock exchange specialists. The objectives and contents of the initiative were presented at a news conference held for business journalists after the event.

7. Presentation on EU capital market legislation

Within the framework of a technical consultation held at the Association, competent senior associates from the Ministry of Finance and the Hungarian Financial Supervisory Authority gave an overview of those European Institutions and legislative processes where Hungarian authorities are represented. In turn, the Association presented the role of the European Banking Federation in the European lawmaking process, its review role and interest enforcing ability. (The Association has been a full-fledged member of the FBE since January 2004).

The creation of a single European financial market and the criteria of effective movement of capital prompted European lawmakers to review the EU's slow, inefficient and untransparent decision-making mechanisms.

The Lámfalussy Process, currently applied to capital market legislation and planned to be extended to banking, insurance and investment funds, is aimed at speeding up the legislative process, allowing the drafting of efficient and practicable legislation that can keep pace with market developments.

The Lámfalussy process is a four level legislative process. A key principle is that **market players should be consulted with** right at the start of the legislative process. This should take place on two scenes: one, when Hungarian regulatory authorities present their views in the various institutions based on consultations with players in the Hungarian market and, second, when the position of the Hungarian banking industry (not necessarily the same as that of the authorities) is represented on the FBE's committees and working groups

The FBE's legislative work is adjusted to this process, the consultative committee for capital market issues is the Financial Markets Committee /FMC/, which has various sub-committees and

working groups. The FMC's position is solicited on all subsequent issues belonging to other consultative committees (for example, payments and securities settlements).

8. Joint event of the John von Neumann Computer Society's Hungarian Smart Card Forum and the Hungarian Banking Association

The professional day organised by the John von Neumann Computer Society Smart Card Forum and the Hungarian Banking Association on December 15 was attended by more than fifty professionals. Presentations were offered on progress and accomplishments in the various smart card application areas. The presentations were followed by a roundtable discussion, where participant questions were answered by representatives from the Ministry of Informatics and Communication, GKI Economic Research Co., the Ministry of Education, the National Bank of Hungary, the Hungarian Academy of Sciences, Mastercard and VISA.

9. Bank security

Bank security specialists were offered the opportunity to participate in a **German-led institutional development program aimed at preventing organised crime.** The program in Hungary is organised by the National Police Headquarters.

The program, titled ***„Supporting police activities in the areas of organised crime, financial crime and corruption***" is aimed at providing training to new units and enhancing the working methods of existing units through implementing the latest EU methods in Hungarian practice.

10. Prevention of terrorism and money laundering

The European Banking Federation set up a database to help banks implement their **anti-terrorism** tasks. This consolidated database contains the details of those persons and organisations subject to financial sanctions within the EU. With this system in place, banks no longer have to follow the complicated process of using the Terrorist Lists published in the Official Journal.

A meeting on the accessibility and use of the system was held by the Association in June 2004. At the beginning of the year, a consultation on current **client identification** tasks and related methods was held with the participation of representatives from the Ministry of Finance.

A similar consultation was held at the end of the year with the participation of the competent leaders from the National Police Headquarters, on uniform practices to be followed in identifying **anonymous deposit** owners**.**

11. Cooperation Agreement with the National Interest-Representation Association of Savings Co-Operatives (TÉSZ)

In the summer of 2004, the Association concluded a cooperation agreement with the National Interest-Representation Association of Savings Co-Operatives (TÉSZ), an organisation comprising 14 savings cooperatives. Under this cooperation, the two Associations undertook to mutually inform each other on the most important professional issues; the Banking Association undertook to involve TÉSZ in legislative reviews to be conducted with Ministries and other organisations and both parties agreed to invite each other to their most important meetings (general meetings).

II. PROFESSIONAL ACTIVITIES

A. REGULATIONS AFFECTING CREDIT INSTITUTIONS' OPERATIONS

1. Special bank tax

Tax laws for 2005 and the Act on a special bank tax imposed for a period of two years were promulgated in November 2004.

The government imposed a special tax on credit institutions and financial enterprises for a two-year period, for 2005 and 2006. Banks expressed their opinion that this special tax was unjustified and economically unfounded, but took note of the extra burden.

To optimise the tax burden, the Association, availing itself of the option offered by the Minister of Finance and the Prime Minister, in collaboration with specialists from member banks developed a technical solution under which credit institutions and financial enterprises may choose between their interest margin or pre-tax profit to be the tax base. Accordingly, in 2005 and 2006 banks and financial enterprises will pay an extra 8% corporate tax or 6% of their interest margin as a special tax. When developing our proposal we looked into several alternatives, assessing the advantages and disadvantages of each option. Specialists from savings co-operatives and financial enterprises were also involved in the work. The proposal submitted to the government satisfies the government's revenue expectations and will contribute at least HUF 60 billon to the budget; the technical solution is in harmony with current domestic taxation practices and is supported by all financial institutions.

Taxpayers subject to Act CII of 2004 on special tax for credit institutions and financial enterprises may choose between their interest margin or pre-tax profit to be the tax base. As a main rule, the Act provides interest margin to be the tax base; the taxpayer may depart from this under an announcement to the Tax Authority. The deadline for such announcement for 2005 was January 31, 2005. According to our information, eight banks decided to be taxed based on their interest margins, the rest opted for pre-tax profit to be the tax base. Banks missing the deadline will be taxed based on their interest margin in 2005.

2. Legislation on amendments to certain Acts related to financial services

This legislation included amendments to the Credit Institutions Act, the Capital Market Act, the Insurance Act, the Act on Building Societies, the Act on Mortgage Credit Institutions and the Act on Venture Capital Companies.

2.1 Credit Institutions Act

Amendments to the Credit Institutions Act covered issues related to deposit insurance, branches of third-country credit institutions, auditors, and the obligation to provide information in Hungarian. Third-country credit institutions are not required to join the National Deposit Insurance Fund provided they have adequate deposit insurance, in accordance with the relevant EU requirements. The rules for complementary insurance provided by the National Deposit Insurance Fund are now more precise. The provisions on bank auditors were modified: natural persons may be appointed auditors for a maximum period of five years; the same person may be reappointed only after a lapse of three years from expiry of his assignment.

The rules for the provision of customer information were modified: unless otherwise agreed by the parties, financial institutions are now required to make available their general terms and conditions of contract, business rules, information on interests and fees and account turnover and deposit insurance information in Hungarian. Based on the Association's proposal, the amendment to the provisions on bank secret allows the provision of information on the amount of the claim and its due date to those third parties who have provided collateral for the risks; in case of contracts concluded through agents, a written statement by the client or its legal representative will now suffice for supplying the agent with the necessary data.

2.2 Capital Market Act

At the request of the Ministry of Finance, the Association submitted its proposals for amendments to the Capital Market Act. Many of our proposals coincided with the proposals of other stakeholders (National Association of Securities Dealers, Hungarian Association of Investment Fund Managers, the Budapest Stock Exchange).

- Apart from some technical codification comments, we expressed our objection to the requirement of rating the customer's risk-taking capacity. We also proposed to reasonably limit the obligation of customer information. At the same time, we proposed to widen the scope of cases where the involvement of intermediaries is allowed.
- For collective deposits we proposed to provide that the customer's consent shall not be required for a custodian to redeposit the securities it has accepted for custody with an investment firm providing securities custody services.
- We proposed that bank guarantees be allowed to be accepted as collateral for securities lending.

2.3 Act on mortgage credit institutions and mortgage bonds

The amendment to the Act on Mortgage Credit Institutions now allows the recognition of derivative transactions concluded on mortgage loans in determining the value of collateral for mortgage bonds. The amendment stipulates the prohibition of alienation and encumbrance as a statutory right. Mortgage credit institutions are required to stipulate the prohibition of alienation and encumbrance in their mortgage, mortgage loan and independent mortgage purchase contracts. Based on these contracts, mortgage credit institutions may request the registration of prohibition of alienation and encumbrance in the land register. The amendment also allows the purchase of mortgage loans and independent mortgages from other credit institutions if the mortgage credit institution in question does not have the right to impose a prohibition of alienation and encumbrance.

2.4 Amendment to the Act on Building Societies

The Act on Building Societies was amended to simplify borrowings: if the beneficiary of the contract is a minor, the utilisation of the loan in favour of a minor is also realised if the home purchase is made in favour of a home saver who is a close relative of the minor and has lived in a common household with the minor for at least one year. This provision is also applicable for existing contracts. The draft law (submitted under No. T/9842 on April 16, 2004) was passed by Parliament.

2.5 Insolvency Act

Under its Resolution No. 1128/2003 (XII. 17.) the government decided to draft a new legislation on insolvency for companies and business organisations. Under this resolution, a codification committee was set up under the leadership of László Keller, Political State Secretary in charge of controlling public finance affairs. The concept of the new legislation was to be completed by September 2004 and the draft law is to be submitted to Government by September 30, 2005.

Represented on the Committee are the Ministries involved, the Hungarian Chamber of Auditors, the Tax and Financial Control Administration, the Supreme Court, the Attorney General's Office, the Hungarian Association of Insolvency Practitioners (FOE), the Hungarian Banking Association and liquidation judges.

The Codification Committee was working almost continuously during the year. The expert summary group, comprising specialists from the Association and member banks, was complemented on the lending side with risk management and workout specialists from member banks, who represented banks' interests with full commitment and at high professional standards at the weekly meetings of the working committee.

At the Codification Committee's fourth meeting, addressing the codification working document, the Association was represented by its Secretary General. In his comments, the Secretary General emphasised the importance of the Act for the banking industry: injuries to lenders' interest may adversely affect lending and economic turnover as a whole. The new legislation should put the most important decisions in the hands of the lenders. Banks have no counter-interest in allowing reorganisation processes to be launched at companies that can be rescued; however, in most cases it is banks who ensure the conditions for continued operations during the reorganisation process and therefore, it is reasonable to give lenders the right to select or dismiss the receivers. Courts should only be given some automatic decision powers.

The concept of the new legislation contained a number of **elements focused on debtor and receiver interests, with lender interests even less respected than in the current legislation** (the elements in question mainly related to the satisfaction of **secured claims** under bankruptcy procedures and the handling of collaterals.

The Association's Board reviewed the concept and submitted its comments in a letter to State Secretary László Keller, as Chairman of the Codification Committee; the Ministers of Justice and Finance were also informed on the Association's position. A breakthrough was achieved in a number of issues at the Codification Committee's meeting of September 16: after a debate, the Committee decided to retain the 50% rule for mortgagees and we were reassured that there was no intention to impair the current regulation of mortgage rights in any respect. As to international regulations on mortgage rights, the Committee will solicit the opinion of the Justice Ministry. The debate over procedural law issues and the legal status of receivers remained open.

The task of preparing a concept and developing a proposal for the new Insolvency Act was transferred to the Ministry of Justice in the fall of 2004. A revised draft concept was sent to the summary working group in November 2004 and reviewed by the Codification Committee in December. The revised concept was a major shift compared to the previous versions. As also reflected in the opinions provided by banks, creditor protection aspects were given more emphasis and were formulated in a more clear-cut manner in the new concept. In our comments we supported the objective that the regulations related to creditors holding material collateral should be developed in such a manner that they do not prejudice the substance of the collateral in question. The Ministry promised to conduct another review and that the concept of the Insolvency Act will be submitted to the government concurrently with the concepts of the Companies Act and

the Company Registration Act. According to current information, the drafting of the Insolvency Act may be carried over to the next parliamentary cycle; it was also mentioned that urgent issues might be tackled under a brief amendment to the current legislation.

3. Credit information system

The Ministry of Justice initiated a review of the provisions of the Credit Institutions Act because, in their opinion, the rules for a central credit information system should be **more specific and complemented with further guarantee elements**. In the Justice Ministry's opinion the central credit information system is not fair in that it does not distinguish between major and minor and defaults and provides limited possibilities for a more detailed information exchange (allowing a better assessment) between banks.

The regulations on a central credit information system in the Credit Institutions Act were changed in two points, effective from October 7, 2004: the credit information provider is obliged to notify the customer in writing on the fact and contents of the information upon entry of information in the BAR system. The second change is that customer information registered in the BAR system may be retained for a maximum period of five years from the repayment of the debt; accordingly, the legislation provides clearly that in case of long-term contracts the start of the retention period is the date when the debt is repaid, not the expiry date of the contract.

The Justice Ministry is of the view that **a more comprehensive review** of the rules governing the central credit information system would be required, with special regard to:

a/ improving customer information,
b/ allowing customer to take appropriate actions to prevent any misunderstanding or illegal measures,
c/ commensurate registration time, differentiated according to the seriousness of the default.

After consultations with banks the Association expressed its support of the Justice Ministry's proposal. At the same time we submitted a number of constructive counter-proposals and proposals for adjustments in certain points. The amendatory proposal stipulates the rules for the current five databases of the system and the related data protection rules and remedies in an integral form under a separate chapter. Some provisions of the current regulation are not clear enough and give rise to different interpretations; the proposal aims to clarify these provisions and to make them unambiguous. The proposal provides detailed regulations concerning customer information and customer inquiries and a special court procedure under which customers may initiate modifications to or cancellation of the credit information maintained on them.

4. Reporting requirements

The National Bank of Hungary (NBH) in the third quarter compiled a guide for monetary statistical reporting for 2005. The Guide was issued as an NBH Ordinance in the fourth quarter. Proposals made by the banking community were duly taken into account in the Ordinance. In the legal hierarchy, the Central Bank Ordinance is equivalent to a Government Decree.

In November we received for review a proposed Ordinance of the Governor of NBH on titling obligations related to the central bank information system. This Ordinance will replace the current Government Decree No. 256/2001 (XII 18). When making international payments, customers are required to indicate the title of payment for statistical purposes. Title codes are ranged by purpose (goods trade, services, investments, etc.) and serve as guides for the central bank in compiling the

balance sheet lines in the balance of payments. Member banks submitted a number of proposals for adjustments to the text of the proposed Ordinance and certain technical problems encountered in practice were also communicated to the central bank. We requested that the responsibilities of banks be clearly specified in the regulation, given that at present banks do not have the means that would enable them to require customers to provide reliable and logically correct information

The Ordinance has not been finalised as yet. The NBH said constructive proposals would be taken into account in the final version of the Ordinance. The regulation is expected to be issued in the first quarter of 2005.

The Guide for Supervisory Reporting for 2005 was published on the Hungarian Financial Supervisory Authority's website in mid-December. The time allowed for commenting was very short, institutions were requested to send their comments directly to the Authority. The Finance Ministry Decree to provide for the reporting requirements had not been promulgated by January 1, 2005; it is expected to be enacted in February 2005.

Under the Act on the Rules of Taxation, EU interest income reporting requirements will be introduced from July 1, 2005. The first reports should be submitted to the national Tax Authority by March 20, 2006. The Tax Authority will gather information on interest payments made to natural person residents of other member states, with the purpose of forwarding the data to the competent member state within the framework of an automatic information exchange within the European Union. A special form will be prepared for this purpose. The Association initiated cooperation with the regulators to allow banks to familiarise themselves with the contents of the form and prepare their IT systems for generating the information required.

5. Data Protection Act

The Ministry of Justice published on its website the proposed amendment to the Data Protection Act in November 2004 (the amendment was necessary pursuant to a Constitutional Court decision). The amendment was related to the transfer of data to third countries and contained amendments to the provisions on the right of access to data of public interest; it also contained provisions to make the definition of the Data Protection Ombudsman's scope of authority more specific. In our comments, in relation to the transfer of personal data to a data manager or a data processor in a third country we proposed that the legislation be further adjusted to the EU Data Protection Directive. We also proposed that the Ombudsman's right to issue recommendations be defined more specifically.

6. Amendments to provisions on pledge in the Civil Code and the Bankruptcy Act

The Association reviewed the proposed amendments to the provisions on pledge in the Civil Code and related amendments to the Bankruptcy Act. Pursuant to the new bankruptcy legislation, if the debtor has provided a pledge against any of its liabilities before the starting date of liquidation, the pledgee may satisfy its claim by using such pledge irrespective of the commencement of the liquidation proceeding and then settle the balance with the liquidator.

With this new regulation, **pledges will constitute a real financial collateral, adding legal security to lending and money and capital market operations**

7. Concepts for the new Companies Act and Company Registration Act

In October 2004 the Ministry of Justice sent us for review the concepts for the new Companies Act and Company Registration Act. In our comments, based on opinions from member banks, we expressed our objection to abolishing the HUF 3 million share capital requirement for limited

liability companies. We made comments concerning the criteria for the separation of open vs. closed operations and expressed our objection to the plan to abolish the mandatory dematerialisation of publicly issued shares. Pursuant to the Capital Market Act, publicly issued printed shares were required to be dematerialised latest by the end of 2004. Accordingly, it would be completely unwarranted to provide for the option of rematerialisation. In addition to some other conceptual issues, we submitted two proposals for amendments to the current Companies Act, aimed at law harmonisation.

The consultation held at the Ministry of Justice in November was also attended by banks who had submitted comments on the concept. The concept is planned to be reviewed by the government in early 2005 and the draft law would be presented to Parliament in the second half of 2005. Our proposal for amendments to the current Companies Act was declined with the explanation that the proposals related to the operations of credit institutions will be presented under a proposed amendment to the Credit Institutions Act and the proposal concerning acquisitions will be included in an amendment to the Capital Market Act.

8. Local trade tax

The Association turned to the Minister of Finance several times in 2004 to seek short and long-term solutions to anomalies in the regulations on local trade tax:

In our opinion, the rules for determining the tax base for local trade tax on investment and other financial services in the relevant Act are **discriminative and professionally unjustified**[1]. There is no plausible reason why revenues from investment and other financial services should be treated differently to those from interest. While the law allows the recognition of interest expenses in determining income from interest, sales revenues from investment services are taken into account on a gross basis in the tax base. In other words, expenses cannot be deducted from revenues in the latter case (as opposed to the rules applied to interest revenues and revenues from other business activities, where cost of goods sold and material costs can be deducted from revenues). To eliminate these anomalies, the Association also filed a motion with the Constitutional Court.

The regulation enacted in 2004 is even more detrimental, although accounting rules in force from January 2004 now allow netting for hedging transactions. The Act on Local Taxes "re-adjusts" this solution by picking out and taxing the profitable element of the transaction.

From budgeting point of view, the main problem is that under the current rules, **local trade tax is unplannable**. When concluding a forward transaction (and the subsequent counter-transaction closing the position), the hedging margin is fixed, while the actual price difference and thus, the profit or loss, are determined by future market developments, while the return/result of the closed transaction remains fixed.

We find it injurious and constitutionally questionable that the amendment enacted as of January is applied not only to hedge transactions concluded after entry into force of the regulation but to all existing agreements concluded before and expiring after entry into force of the new regulation (**retrospective regulation!**).

The problem is just aggrevated by the introduction of an innovation contribution to the Innovation Fund from 2004. The creation of an Innovation Fund in itself is welcomed. The problem is that the base of this contribution is the same as that of trade tax and is currently 0.2% (annually increasing), which means a 10% increase in the local tax burden.

[1] Paragraphs b) and e) of sub-section 22 of Section 52 of Act C of 1990

The regulation is also detrimental to corporate clients. When applying fair value accounting as provided by the Accounting Act, as a new element, 50% of the gains on interest hedge transactions should be included in the trade tax base.

Foreign exchange hedging, as an efficient risk management tool has been increasingly popular among clients in recent years. A similar process could start now with interest hedging, as an indispensable tool for covering risks in a volatile interest market. This is a positive process, the engine of growth in these markets and one of an overall economic importance. The current regulation is counter-productive to this process.

The problem is not marginal: it affects all banks and investment firms offering hedging, investment and other financial services.

Our proposal to resolve the problem is as follows**:**

- **as an instant measure:** recognising the costs of derivative transactions to reduce the tax base, in line with the relevant international practice, and
- recognising investment services on a net basis in the tax base; for other financial services: allowing the deduction of all costs that can be specifically linked to commission revenues.
- **as a long-term objective:** determine the tax base on a new basis, e.g.: align with corporate tax base.

We requested the Minister of Finance to address the matter not just as a trade tax issue but to also consider its overall effect on the financial markets and on the size and future development of the entire banking sector. Beyond resolving this issue we proposed that **a comprehensive work be launched to review all potential areas where the conditions or regulatory constraints cause banks a competitive disadvantage** and to identify positive measures whereby it could be ensured that, for example, the government securities market stays in Hungary. We also proposed to identify appropriate measures to promote the continued growth of the financial sector as a whole and delay the migration of markets to other countries (a process that is expected to intensify with the introduction of the Euro).

The proposal for amendments to the laws on taxes, contributions and other fiscal dues provides the following definition for net revenues:

„b) for credit institutions and financial enterprises: interest and interest-type revenues received, as reduced by interest and interest-type expenses paid, and increased by revenues from other financial services, revenues from investment services and net revenues from non-financial and non-investment services. For hedging transactions, net revenues shall include the profit obtained as the difference between the gain/loss on the main transaction (the hedged item) and the gain/loss on the hedging transaction."

Although this proposal is a significant improvement compared to the current regulation and also allows the recognition of a certain portion of trade tax in corporate tax, the Association and banks continue to argue for the solution that net revenues are computed on a real net basis for all investment and other financial services.

9. Home loan schemes

9.1 Amendments to the regulation on housing subsidies

After due preparations, the government decided to translate its new housing program into legislation by the end of 2004. A loan scheme involving government guarantees was introduced

under a separate regulation to promote home building by young people and the regulation on housing subsidies was also changed significantly. The Association was actively involved in the drafting of both decrees.

The government's "nest-making" program is aimed at helping young people who are not able to raise the 40% to 50% in own resources required under current lending practices. The state provides a guarantee for the part of the loan replacing the required own resources, thereby promoting the creditworthiness of the borrowers. With additional government subsidies provided for the remaining 10% of the loan amount (such as social policy supports), in a lucky case one may be able to purchase an apartment without a single penny of own resource. Higher borrowing of course means higher instalments, which not everybody can afford (the legislators targeted young couples with higher income). The regulator tried not to tie banks' hands, the loans can be made available under the most diverse loan facilities (including foreign currency loans).

Banks, in cooperation with the regulator, tried to develop a workable loan scheme. As a result of this joint effort is was possible to ensure that

- the scope of eligible borrowers is not reduced substantially (involvement of a co-debtor for better risk management; income status is not the only decisive factor in credit rating; children moving together with the borrowers be eligible for acquiring title - often a precondition for grandparent supports),
- the part of the loan covered by state guarantee – originally envisaged to be precedent to all other debts - will be treated equally to other parts of the loan and risk-sharing between the government and the bank will be maintained until the end of the loan period.
- the state guarantee fees shall not be paid by the banks (however inapplicable, the idea did arise in earnest in the course of drafting the legislation; it will be for the customer to decide whether he will pay the fee in advance or ask the bank to provide a loan for the fee).
- to ensure level playing field, the regulation will also allow banks other than mortgage banks to put those state-approved collateral rating rules in place that are prerequisite for the provision of state guarantee;
- with the introduction of expected collateral value, the loan facility may now be extended to the construction of new apartments.

Some of our proposals were only partly taken into account or not at all:

- to ensure wider access to the loan we proposed that the age limit of 30 years be increased to 35 years (the proposal was rejected due to budget constraints; however, the new president of the National Housing and Construction Office did not rule out that this, rigid, rule will be amended in the near future);
- the state guarantee does not extend to late interest for default on the guaranteed part of the loan;
- despite promises, banks were given less than a month to develop this complex loan facility.

9.2 Annual Percentage Rate for home loans

Pursuant to an earlier amendment to the Credit Institutions Act, APR should also be indicated for home loans, effective from January 1, 2005. Although we have been consistently objected to this provision (the APR can only be calculated with over-simplifications and in a distorted manner for these products), we developed and submitted our proposals the Ministry. The new draft legislation was received from the Ministry for review in mid-October.

Given that a number of our proposals were incorporated in the proposed legislation, in our comments we focused on those proposals which were not included in the draft. In the first place, we argued for third-party fees to be omitted from the calculation of APR. We explained that costs such as notary fees, appraisal fees or insurance premiums are largely dependent on the specific terms and conditions of the deal and the customer's circumstances. Consequently, it is impossible to estimate these costs in an advertisement (the primary place where the APR is to be used). The calculation of APR for direct offers or contracts (where a lot more details of the deal are known) is no simpler, either. Notary fees (charged after concluding the contract and often depending on the notary's pricing policy) and insurance premiums (normally determined after the contract is concluded, insurance being a precondition for granting the loan) are always determined subsequently; consequently, the APR would lose its role as a guide helping the customer to choose between different offers.

In our comments we proposed an adjustment to the method for determining the exchange rate for foreign currency loans and provided a specific wording proposal for the method of calculating APR for credit cards. We expressed our objection to indicating the APR in banks' Business Rules and in loan contracts and pointed out that Business Rules are more of a general nature and should not contain product-specific terms and conditions, which are constantly changing.

After several rounds of consultations, a compromise was reached. The Ministry accepted our argument that most third-party fees cannot be specified in advance and consequently, cannot be included in the calculation of the APR. (Only appraisal fees and inspections fees were retained in the proposal). Nevertheless, fees known by the bank or a closer estimate of such fees should be made known to the customer at the time of concluding the contract.

In the APR requirements for foreign currency loans and credit cards, the Ministry followed the Association's proposals. However, the requirement for APR to be indicated in the contract was retained in the proposal (it is true that to change it, an amendment to the Act would have been required); the regulation regarding the indication of APR in the Business Rules was only partly changed (it would not be required to indicate in the APR for home loans in the Business Rules). For consumer protection purposes, type-specific values and typical maturities were set for the different types of home loans to ensure that the APR is indicated as a specific figure rather than as a meaningless (from/to) range. In their List of Conditions and offers, banks should include a statement that exchange rate and interest rate risks are not reflected in the APR. In our opinion this provision is based on a complete misunderstanding of this indicator: APRs compare prices in the present time and cannot handle future risks at all.

10. European Master Agreement

The Hungarian translation of the European Master Agreement (EMA) providing a standard framework for repo and securities lending transaction was completed and reviewed by banking professionals and is now available at the Association's website: **(**www.bankszovetseg.hu/velemenyek, members only). The text provided by the EMA can be freely used by all banks. The supervisory approval process is now underway and, once concluded, the Allen & Overy law office will issue its legal opinion.

11. National Qualifications Register (OKJ) qualification requirements

The Association reviewed and provided its comments on the proposed Decree on certification and examination requirements for persons acting as salespersons, sales representatives and investment advisors within investment firms.

The proposed decree would provide unreasonably strict conditions for obtaining the required certificates, which would pose extremely difficult requirements for those employees engaged in the sale of banking, investment and insurance products and imply substantial extra costs for employers as well. Given that the proposed new training and certification system would affect all sales employees within banks and savings cooperatives, the Association and the National Association of Savings Cooperatives (OTSZ) jointly turned to the Minister of Finance to seek a compromise. In our reasoning we pointed out that the relevant vocational training system would be much more stringent than in other EU member states and would therefore lead to a competitive disadvantage, especially in relation to the new member states. Accordingly, it might happen that if the registration of agents is easier in a neighbouring country, then some providers may decide to move operations to that country.

Ministry of Finance Decree No. 2/2005 (I. 7), published in the Hungarian Gazette on January 7, 2005, contains the qualification and examination requirements for insurance brokers, bank clerks, banking/investment product salespersons, foreign currency tellers and foreign currency clerks, basically as provided in the draft. The relevant Government Decree has not been issued to date.

12. Financial services contracts concluded within the framework of remote sales

In relation to the draft law received from the Ministry of Finance for review we repeatedly drew attention to the inconsistency between identification requirements, which presume personal contacts, and the conclusion of contract between remote parties. Further, we objected to allowing a subsequent rescission of the contract by the customer in the case of contracts concluded via mail.

B. PAYMENTS

1. Amendments to payment regulations

A general review of the regulations on payments has been on the agenda since 2003. Regulatory tasks have been split between the Ministry of Finance and the National Bank of Hungary: the Ministry of Finance, through a Government Decree, sets the principles for domestic payments and provides the rules for cross-border payments, the National Bank of Hungary provides the rules for the technical management of payments. During the past one year, credit institutions had the chance to express their views on the proposed regulations several times. As a new practice, all three sides gave special attention to the relevant EU aspects: the central bank consulted with the European Central Bank, the Ministry of Finance took into account the proposed new EU framework for payments, while the Association used the arguments of the European banking industry, summarised by the European Banking Federation.

The followings were accomplished during the consultation:

- The main elements in domestic collections in foreign currency were clarified: the payee has the right to receive the amount in foreign currency and this issues should be handled in the payment form; the payer's bank may not convert the collection order into HUF (the bank is even obliged to convert the payer's HUF deposits into foreign currency, if necessary); the order of accounts to be involved in the collection will also be regulated as well as the sharing of costs between the parties. (Given that currently our Giro system is only able to perform HUF transfers, SWIFT will be used as a transfer channel).

- Modest progress was made in the area of electronic money regulations. The key issue here is that the current regulation had originally been designed for bank card payments; since then, a number of other, remote banking, instruments, different from bank cards in nature, risks and security

parameters have been developed (including internet, mobile and office banking). We reviewed the current regulation with the competent staff of the Ministry of Finance and made a concrete proposal, specifying those rules that should only be applied to bank cards and those that should be applied to other electronic payment instruments.

- Based on a preliminary survey with banks, the issue of liability was addressed. We drew the regulator's attention to the fact that the amount of a payment performed through a remote banking instrument may be a hundred times (!) that of an average bank card transaction amount (HUF 27,000). We proposed that this difference, at least partly, appear in the customer's risk (thereby, the incentive for fraud could also be reduced). In our letter to the Ministry of Finance we specifically emphasised that the current consumer protection provisions, dimensioned for bank cards are completely inadequate for remote banking transactions performed by major companies: a transfer order in the case of these companies may be in the range of several hundred millions of forints and in case of a dispute, these companies are backed by strong professional legal teams. Finally, the issue was resolved by the EU: the consumer protection provisions in question will not apply to major companies under the proposed new Directive of payments.

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- - We also referred to the proposed EU Directive regarding the resolution of disputes between bank and customer when proposing that the burden of proof should be mutually with the bank and the customer, as opposed to the current regulation where the burden of proof is solely with the bank. (Here, it should be mentioned that interest enforcement works two ways: after preliminary consultations with the involvement of bank specialists we achieved that Hungarian banking's position that the bank card-focused regulations in the proposal should be revised and adjusted to the specifics of other electronic payment instruments is included in the Hungarian position on the proposed new EU Payments Directive. This lobbying activity, by the way, is in line with the FBE's expectations).

- Progress was made in some key technical issues as well: the term "value date", which had caused several misunderstandings was tied to the international interpretation (linked to interest); for bank accounts, the term "debit date" was introduced, meaning the date specified by the customer in advance for debiting the account.

Improving and making the definitions in the regulations on payments more specific will continue to be a key issue. Parallel with a traditional manual processing of payment orders there is increasing customer demand for new electronic payment channels, which requires increasingly complex regulations. Up-to-date solutions supporting automatic processing are needed. With constant changes in this area, preparations should be made for a transparent regulation, adjusted to new payment processes, providing an adequate level of security and strengthening customer confidence.

In addition to payments specialists from member banks, members of the Legal Working Group of the Payment System Forum were also involved in the review of the proposed regulation, including consultations with the Ministry of Finance and the National Bank of Hungary. In the course of the inter-ministerial review preceding the issue of the regulation, banks will have the opportunity to check on how their aspects are reflected in the proposals to be adopted by the government.

2. Changes on the currency exchange market

The Ministry of Finance requested the Association's assistance in assessing the effects of a major development in the currency exchange agents' market: the bank that had employed the most currency exchange agents (approx. 200 in number) quit this business; those few banks that

remained in the currency exchange market only took over a limited number of agents. The Ministry wanted to know how this drop in the number of players would affect the market.

Based on the assessments received from our member banks, we provided the Ministry with the following information: the information that the number of currency exchange agents has significantly decreased is correct, one of the reasons being that the banks that have still remained in this line of business are selecting between the agents. However, this should not affect clients, given that some of those agents that have dropped out had operated in saturated market segments, while in the case of some others there had been some doubts anyway as to whether they would have been able at all to cope with an adequately stringent control system. The general opinion was that the process may be regarded as a purification process in the market and a tight control by banks is better fitted to the spirit of the preceding amendment to the law, putting currency exchange operations under a full banking control.

It is true that some market players offering low rates have disappeared from the market; however, banking experts say these low rates could only be maintained by evading a tighter banking control and thus, saving the costs involved. Banks are not concerned about the developing of any blank spots in the market: in their opinion the remaining currency exchange agents do have the flexibility and financial strength to be able to fill any potential gaps in the market.

3. Act on electronic money institutions

Professional reviews of the proposed law were conducted by banks between November 2003 and end of February 2004. The Ministry of Finance and the Association were also involved in the reviews. Act XXXV of 2004 on Electronic Money Institution was passed by Parliament on April 26, 2004. This Act regulates electronic money issuing activities and their prudential supervision, in accordance with Directives No. 2000/46/EC, 2000/12/EC és a 2000/28/EC.

C. CONSUMER PROTECTION

1. Ombudsman's report

Upon citizen complaints, the Ombudsman for Citizen Rights compiled a report on banks' mortgage lending practices. The Ombudsman's Office first informed the press on their findings, which were seriously detrimental to banks. The Ombudsman's report along with his recommendations for actions were subsequently sent to the competent authorities (the Ministry of Finance, the Hungarian Financial Supervisory Authority, the Competition Office) and the Banking Association. While the Ombudsman may only recommend actions to state organs, not to the business sphere (and thus, neither to banks), his recommendations clearly expected substantive actions from banks and their regulatory authorities.

The Association informed the Ombudsman in writing on banks' opinion, disproving his critical statements. We expressed our objection to the way the report was compiled and made public as well as to the contents of the report.

- We rejected the criticism that banks are artificially underrating the real estate collateral provided: the methods for collateral rating are **provided for by statute**; consequently, the fact that banks follow similar practices is not due to a cartel but to a law-abiding behaviour;
- Contrary to the report, on the one hand: the stipulation of a buying option is not unconstitutional, as also pronounced by the Supreme Court; on the other hand, not all banks

require this type of collateral, consequently, there is no grounds for claiming a cartel in this case, either. We drew attention to the fact that the reason for some banks' using this (tough, but fully legal) instrument is rooted in the extremely low efficiency of execution procedures (supposed to be the normal way for enforcing claims);

- We agreed with the Ombudsman's opinion that the stipulation of a buying option for undervalued collateral is customer-unfriendly; however, banks confirmed that before using a buying option, the collateral is re-rated by an independent appraiser and then sold at a new and fair price.

Parallel with this letter, the Association's President and Secretary met with the Ombudsman and presented him the profession's views and position also in person. Several questions were clarified during this meeting and both the Ombudsman and his experts admitted that some of their statements, particularly those criticising banking practices, were unjustified. The parties decided to set up a joint committee to review those issues still found problematic and to develop proposals for appropriate solutions.

2. Consumer protection amendments to the Credit Institutions Act

The Ombudsman for Citizen Rights made a number of consumer protection recommendations to the competent authorities in his report on mortgage lending. Largely prompted by this, the Ministry of Finance drafted an amendment to the Credit Institutions Act to address the Ombudsman's recommendations and to adjust and complement the rules for the debtor database (BAR) in response to Hungarian Financial Supervisory Authority's requests concerning consumer protection.

According to the proposal, in the case of mortgage loans the bank would be obliged to provide a risk statement on **risks related to exercising the buying option and exchange rate risks related to foreign currency loans** and this statement should be countersigned by the customer. Also, in case of exercising its buying option the bank should give the customer 90 days to try to sell the real estate collateral on his own. The proposal also contained provisions for claim enforcement rules to be stated in the banks' business terms and conditions.

While agreeing with the Ombudsman's opinion regarding the need for measures to improve customer information, banks found the proposed regulation exaggerated and, in some aspects, incorrect. Regarding the risk statements it was raised that there are number of other significant risks facing the customers (interest rate, repayment, suretyship, pledge) and it is impossible to issue separate statements for all those risks. Notwithstanding, banks find it important that the risk statements have uniform contents to avoid customer arguments that the risk statement of another bank was much more elaborate and based on that he would not have taken the loan. Accordingly, we proposed that the risk statements be drafted and signed by a recognised professional organisation. We proposed the Hungarian Financial Supervisory Authority to take up this task (the Supervisory Authority did not refuse the informal request at that time). We also asked the legislators to allow for time for the preparations required.

We expressed our objection to an extended regulation of buying option: buying option is a specific legal institution which is regulated by the Civil Code and, therefore, cannot be changed by the Credit Institutions Act. Apart from legal technicalities, we submitted a number of reasonable counter-arguments against the sale of the real estate by the customer. A bank would only exercise its buying option if the customer has defaulted on his contractual obligation despite several attempts to restore its ability or willingness to pay. In such cases, the relationship between the parties is spoiled and the customer may cause further losses during the 90-day period proposed.

We rejected the proposal to include claim enforcement rules in the banks' business conditions. Currently, all additional obligations are stipulated in the contract and it would be difficult for the

customer to trace these important points in the bank's Business Rules. Banks' already complex Business Rules would be stuffed with descriptions of various additional obligations related to the various contracts and the various methods of enforcement (as these are not uniform, either). Such a volume of Business Rules would be confusing rather than helping the customer. We proposed that these obligations continue to be specified in the loan contract.

Most of our proposals were accepted. The provision on the 90-day deferral for sale by the customer was dropped and so was the idea for additional obligations to be stated in the banks' Business Rules. However, the obligation for banks to provide risk statements was retained in the draft law.

III. INTERNATIONAL RELATIONS

1. FBE Banking Supervision Committee - Capital Adequacy Working Group

1.1 Capital adequacy requirements

1.1.1 Basel II

The Basel Committee published **three new documents at the end of January.** In these, it presented a more detailed proposal for the treatment of expected versus unexpected loss, simplified the treatment of securitisation (abandoning the supervisory formula) and set principles for the approval by the home and host country supervisors of the application of AMA for operational risk. In the attachment to its January Communication, the Committee gave its position **on Pillar 2**.

In its **May 11 press release**, the Basel Committee on Banking Supervision announced that it has achieved consensus on the remaining issues regarding the proposals for a new international capital standard and the text of the new framework will be published at the end of June 2004. The standardised and foundation approaches will be implemented from year-end 2006, the advanced approaches from year-end 2007. The floors on both foundation and advanced approaches in 2008 and 2009 would be 90% and 80%, respectively. The floor on the foundation IRB approach will be 95% in 2007. Agreement was reached that the required **capital charges for qualifying revolving retail exposures (QRRE)** will be aligned to the results of recent empirical studies. The Committee has given guidance on **assessing loss-given-default (LGD) for "economic downturns**" but has for the time being not provided for the computation of LGD for stress situations. The Committee believes it is important to maintain the overall level of minimum capital requirements, while also providing incentives to adopt the more advanced risk-sensitive approaches of the new framework. The Committee believes it is important to maintain the overall level of minimum capital requirements, while also providing incentives to adopt the more advanced risk-sensitive approaches of the new framework. The Committee will further review the calibration of the new framework prior to its implementation. Should such review reveal that the objectives on overall capital would not be achieved, the Committee will take actions necessary to address the situation.

The Committee emphasises the importance of **closer coordination between supervisors**. It has provided further high-level principles for **the cross-border implementation of the new framework**, in addition to those published in August 2003[2]: supervisors should closely coordinate their information requirements and approval and validation work and the home jurisdiction should play a leading role in the approval and validation of advanced techniques. The Committee also responded to the comments and questions it had received from various industry participants on its

[2]High-level principles for the cross-border implementation of the New Accord, August 2003.

paper on home-host supervisory principles[3] for the advanced measurement approaches (AMA) for operational risk (AMA home-host paper).

The final text of the new capital accord was published in June as planned, under the title **"International Convergence of Capital Measurement and Capital Standards: a Revised Framework"[4]**. The accord was revised compared to CP3 in accordance with the Committee's announcements of October 2003 and January and May 2004.

The Committee expressed that additional work of a long-term nature will be needed in the **definition of eligible capital** and this work will not be finished before the introduction of the new capital accord. The Committee recognises the importance of continued dialogue regarding the performance of such models and their comparability across banks. The Committee also recognises that the advanced IRB approach represents a point on the continuum between a purely regulatory measurement of credit risk and an approach that builds more fully on internal credit risk models.

1.1.2 EU Capital Requirements Directive (CRD, formerly CAD3).

The European Commission responded in a response paper in March to comments received on CP3. In its response the Commission firmly supported the simultaneous introduction of Basel II and CAD3 and reaffirmed that the EU framework should be consistent with the new Basel Capital Accord. The Commission recognised the need for the directive to be adequately flexible and reaffirmed its commitment to carrying on further consultations on future amendments to be made to the Appendix and to implementing the Basel changes to the trading book**.**

At the request of the European Commission, PriceWaterhouseCoopers made a **study on the financial and macroeconomic impacts of the new capital requirements on the European market**. The conclusions of the study were published in April. The report envisages a slightly positive overall impact. The capital requirements for retail and SME portfolios are expected to decrease, with a minimum change in corporate portfolios. The new capital directive will only have a limited impact on pricing practices. However, it will fundamentally change bank's risk management practices, with a substantial improvement in rating and information systems and databases. PwC do not confirm the fears of a competitiveness impact. The report estimates the implementation costs of Basel II to be EUR 20 billion to 30 billion (EUR 80 million to 150 million per large bank) between 2002 és 2006. To be added to this are the costs arising at the supervisors.

A new working group was set up at the beginning of the year to promote the finalisation of CAD3. Member states were given the chance to express and coordinate their views in the working group. Consultations with member states for fine-tuning the text were focused on consolidation levels, the concept of lead (or coordinator) supervisor, supervisory disclosure requirements, the treatment of investment firms and the streamlining of Pillar 2.

Following the adoption of the Basel Accord in June, the European Commission published the proposal for the new Capital Adequacy Directive, to be enacted **in the form of amendments to the Banking Consolidation Directive (Directive 2000/12/EC) and the Directive on the Capital Adequacy of Credit Institutions and Investment Firms (Directive 93/6/EC).**

The proposed amendments to these directives follow the June Basel Accord; a specific objective of the Commission was to reduce the differences between the European regulation and international agreements to the minimum. However, there is already a difference in the scopes of application:

[3] Principles for home-host recognition of AMA operational risk capital, January 2004.
[4] International Convergence of Capital Measurement and Capital Standards: a Revised Framework

while the Basel Accord applies to internationally active banks (groups, financial conglomerates), the Directive will have to be applied by all EU-based banks and investment firms on individual and group levels (national supervisors may give an exemption from an individual application). Another difference is that the European regulation allows the use of the standardised approach for sovereign and institutional portfolios (banks, investment firms, municipalities) even in case other portfolios are measured by using the IRB approach. The new regulation does not affect the differences in definitions, which will continue to remain. The European regulation will allow a 0% risk weighting for domestic intra-group exposures at national discretion, once certain conditions are met. In the proposed EU regulation, its will suffice to calculate the capital requirement for operational risk on group level, if so decided by the national regulator. Contrary to expectations, the Commission did not reduce the scope of national discretions significantly, compared to the Basel Accord.

The new Capital Requirements Directive will be adopted by the European Parliament and the European Council under a co-decision process. To prepare the Council decision, expert-level consultations are being conducted by member states, Hungary is represented by a representative from the Ministry of Finance. (In Hungary, the Ministry of Finance invited a review with the participation of the National Bank of Hungary, the Hungarian Financial Supervisory Authority and professional associations to develop a Hungarian position on the proposed Directive. At the consultation, the Association submitted a number of proposals for modifications and adjustments to the proposed Directive. Most of our proposals were incorporated in the Hungarian position sent to Brussels).

Eager to have the Directive adopted by the Council with the minimum possible changes and within the shortest possible time under the Dutch presidency, the European Commission in the competent working group tried to avert proposals made by member states to modify or clarify the text. The Commission would like to have the text adopted by the Council by the end of December. Issues were ranged according to political and professional importance into four categories (Lists A, B, C and D). List A comprised three issues of political nature, related to implementation dates, consolidated supervision and the treatment of 730k investment firms. List B contains some forty issues of political nature, a compromise proposal for the text to be presented to Parliament was drafted by the Council's working group. Items contained in Lists C and D related to technical issues and corrections. The issue of reducing national discretions was assigned to the Committee of European Banking Supervisors (CEBS)[5].

After discussions within the Council's working group, the Presidency of the EU Council in December submitted a **compromise proposal for amendments to the Capital Requirements Directive (CRD)[6]**. The proposal was supported by most member states, but Ireland, Poland, Latvia and Slovenia objected to the provision of Article 129 according to which in case the home and host country supervisors fail to agree on approving the IRB approach for six months, the home country supervisor will make the decision. The objecting countries are of the view that approval must in all cases be based on agreement between the supervisors. Furthermore, the Hungarian representative tried to achieve that in the period of joining the Euro-zone, euro-denominated government debts be weighted at a preferential zero per cent weight, as domestic currency-denominated debts are.

The compromise proposal for amendments to the Capital Requirements Directive, consistent with the June Basel Accord, was endorsed by ECOFIN on December 7. As for previously debated issues: as previously agreed, the dates of introduction will be January 1, 2007 for the standardised and foundation IRB approaches and January 1, 2008 for the advanced IRB approach. ECOFIN requested the Presidency to liaise with MEPs in order to ensure that the Capital Requirements Directive is possibly passed in first reading. The issue of weighting euro-denominated governments debts will be decided on in the course of the Commission procedure.

[5] Committee of European Banking Supervisors:
[6] The new name of the Directive, formerly CAD3

According to Alexander Radwan, the EP Rapporteur on the CRD, the pace set by the Dutch Presidency was too fast. He says passing the Directive in first reading would only be possible if the points made by the European Parliament are reflected in the amendments. MEP's are particularly concerned over the possible impacts of the Directive on SMEs, small banks and consumers. As time progresses, translation is becoming a growing problem. Translations into the main languages are expected to be ready by end-January, without the annexes. Pursuant to the relevant regulations, Mr Radwan may only submit his report to the Commission after the Directive has been translated into all languages and submitted to the European Parliament. According to the information available it is not sure this will happen until the summer.

1.1.3. FBE position on the Capital Requirements Directive

The FBE's Capital Adequacy Working Group and Banking Supervision Committee continued to follow closely Basel II and the proposed Capital Adequacy Directive and tried to influence the developments in accordance with the consensus of its members. In its lobbying activities the FBE has ever since the beginning emphasised the importance for the EU Capital Adequacy Directive to be adjusted to and introduced simultaneously with Basel II, including the amendments concerning trading books. Main priorities in the FBE's lobbying activities included the reduction of national discretions, the introduction of supervisory disclosure requirements, application of the capital requirements at group level and exemptions from an individual application and the zero weighting of intra-group claims and the treatment of securitisation by taking into account European market specifics. The FBE welcomed the inclusion of a model for coordination between supervisors. It challenged the Basel Committee's "hybrid" approach to determining the capital requirements for operational risk in the home and host countries by using the AMA approach; it welcomed the intentions to streamline Pillar 2 and emphasised that the supervisory review process should be applied at group level; it stressed the importance of monitoring procyclicality and the recognition of the geographical diversification effect.

The FBE's **proposals for modifications to the proposed Capital Requirements Directive** were aimed at ensuring a consistent single market. The FBE proposed that exemptions from compliance at individual entity level are not decided by national supervisors: instead, compliance at group level should suffice once certain conditions are met. The FBE also proposed that the application of a 0% risk weight for intra-group exposures (a national discretion) should be applied to intra-group members within the EU as a whole. The FBE expressed its objection to having two options for the risk weighting of institutions in the standardised approach and to the national discretion option concerning effective maturity requirements in the foundation IRB approach. The FBE urges for close cooperation between supervisors and supports the notion of Lead Supervisor. The FBE believes that the supervisory review should only be applied at group level and not at individual entity level and the same applies to the measurement of operational risk under the advanced approach.

The FBE summarised its position on the Capital Requirements Directive in a lobby package. The purpose of the package is to allow the FBE's staff and member organisations to explain and enforce the FBE's position at the various decision making levels of European institutions and member states (regulators, ministries, MEPs). The lobby package summarises the key priorities addressed by the FBE. The objective of the FBE's communications is to promote an early adoption of a flexible European capital requirements directive, consistent with the Basel framework and promoting convergent implementation within the EU, all this with a view to preserving the competitiveness of European banks.

In its press release issued after the ECOFIN meeting, the FBE welcomed ECOFIN's general approach to the CRD. However, the press release also emphasises there was still significant work to be done before European banks could enjoy a coherent supervisory framework within the EU.

Based on its lobbying with MEPs and competent persons at the Commission, the FBE' Secretariat concluded that there was not much chance for the proposals developed by the FBE's working group and adopted by the Banking Supervision Committee to be passed. Accordingly, the FBE's modified its CRD strategy at the beginning of 2005: as a minimum target, the FBE will work to have the issue taken up publicly as an objective on the European Commission's agenda for the coming years.

1.1.4. Review of capital requirements for trading book items

A review of the regulatory framework on trading book items before implementation of the new capital accord is a must. To ensure this, the Basel Committee and IOSCO set up a joint working group. Main issues addressed by the working group include: counterparty risks in OTC derivatives and repo transactions, short-term credit risks, unrealised transactions, credit risk mitigation, double default and the recognition of goods collateral for trading book items. The joint working group conducted a questionnaire survey in July to better understand the treatment of trading book risks in practice.

In December, the FBE, jointly with other organisations turned in a letter to the Presidents of the Basel Committee and the IOSCO Technical Committee. In their letter the parties point out that issues related to the regulations on trading book items can be ranged into two groups. The first group includes issues related to credit risks (counterparty risks, double default, short-term credit risks, unrealised transactions, goods collateral, etc.), which the regulators and the profession have addressed for quite some time (including during the reform of the Capital Accord). The second group includes issues related to the treatment of market risks, such as less liquid assets, and the classification of banking/trading book items. These issues have not been addressed in details during the reform of the capital accord and are therefore fairly new. The letter proposes that the two groups be treated separately.

1.1.5. CEBS documents

Formed in January 2004, the Committee of European Banking Supervisors (CEBS) at the end of April and in May issued three important documents, on consultation practices proposed by the CEBS, on Pillar 2 and on outsourcing.

To be able to efficiently perform its duties, the CEBS is organising a broad consultation with market players, consumers and end-users of banking services. The CEBS would like to conduct the consultation in an open and transparent manner and seeking consensus. Decisions adopted during the consultations will be published. The CEBS will share all information as available and will allow sufficient consultative time for forming an opinion. For key issues, the CEBS proposes a three-month consultative period. Comments will be duly considered and published. All main comments will be answered. Further consultations will be invited where essential issues are revealed from the comments or if the new proposal to be developed based on the comments received substantially differs from the original.

The CEBS document on Pillar 2 addressed issues related to the Internal Capital Adequacy Assessment Process[7] and the Supervisory Review and Evaluation Process[8], setting out 11 High Level Principles for each process.

In relation to the CEBS's 11 high-level supervisory principles on Outsourcing the FBE cautioned against setting overly-prescriptive procedures which could result in interference in the contractual relationships.

1.1.6. U.S. developments

Introduction of the new capital accord is the subject of fierce political debates in the U.S. The President of the OCC[9], John Hawke considered even the end-2006 introduction date as unrealistic and expressed its doubts as to the chance of deciding on some key issues (such as the treatment of credit card loans, assessment of LGD for economic downturns and amendments to the treatment of trading book items) before adoption of the Accord.

Basel II is envisaged to be introduced in the U.S. according to the following schedule:

- September 2004 - 1st Quarter 2005: Fourth Quantitative Impact Study (QIS4)
- 2nd Quarter 2005 (at the earliest): submission for consultation of the Notice of Proposed Rules
- 90-day consultation period; may be extended to 180 days
- issue of final regulation (realistically 3 months after conclusion of the consultation period).

1.2. Extension of the Lámfalussy process to the banking sector

A package of measures aimed at extending the Lámfalussy process to the banking sector was adopted by the European Commission on November 6, 2003.[10] The following are the elements of this package:

- the references to committees in the banking and insurance directives will be replaced with references to Lámfalussy Level 2 committees. (For banks, the Banking Advisory Committee will be replaced with the European Banking Committee)
- establishing an ECB advisory capacity, as a prerequisite for the ECB's regulatory powers in the directive-making process
- Setting up the CEBS (Committee of European Banking Supervisors) Level 3 Committee, as of January 1.

A problem in this process is that in the course of applying the Lámfalussy process, the European Parliament has the power to comment on the application rules (of Level 2) but may not block them. The European Parliament should be given the power to stop the debate on the application rules if they are not in accordance with the objectives and principles set in the directive; for this, however, an amendment to the European Agreement would be required.

1.3. Financial Services Action Plan (FSAP)

The FBE and the Banking Supervision Committee jointly reviewed the progress of the Financial Services Action Plan and, in relation to the integration of EU financial markets, concluded the following:

- The convergence of supervisory practices is a primary objective.

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[7] ICAAP – Internal Capital Adequacy Assessment Process
[8] SREP – Supervisory Review and Evaluation Process
[9] Office of the Comptroller of the Currency:
[10] The extension of the Lámfalussy process to the banking and insurance sectors was adopted by the European Parliament's plenary session of March 31, 2004.

- Improving transparency and the application of a lead (coordinator) supervisory model are prerequisites for achieving convergence.
- The future structure of banking supervision in the EU continues to be a debated issue. (It was mooted that the supervision of internationally active banks could be performed by the CEBS; however, member states have different opinions on this issue).
- The few constraints to integration are:
    - National supervisors' resistance to supervision by a foreign supervisor.
    - The deposit insurance directive may hinder active banks in the reconstruction process.

1.4. Implementation of the Financial Conglomerates Directive

The FBE's Secretariat met with representatives of the European Commission and national supervisors to review issues related to the implementation of the Financial conglomerates Directive. Members states reaffirmed their conviction that the Directive will be adopted in national legislations before the August 2004 deadline. Issues encountered in the implementation of the Directive are being investigated by the Mixed Technical Group on the prudential supervision of financial conglomerates. Issues addressed by the MTG will be made available on the DG Internal Market's website.

2. Accounts Committee

Adoption of IAS 39 in the EU

During the work within the European Accounting Regulations Committee (ARC) aimed at the **adoption of international accounting standards**, there was a lengthy debate over IAS 39 (this standard significantly affects the accounting of banking products). Finally, the Committee decided on a partial adoption of IAS 39. Impacts of IAS 39 on the banking community were discussed in details several times by the FBE's Accounts Committee.

Regulators and the European banking industry submitted objections to the parts on the fair value option and hedge accounting and initiated several amendments to the standards.

- Dissatisfied with the Exposure Draft titled "Fair Value Hedge Accounting for a Portfolio Hedge of Interest Rate Risk", the FBE developed an alternative proposal to address the issue. The Interest Rate Margin Hedge (IRMH) Proposal is a significant step forward in that it is in full conformity with banks' risk management practices, provides a satisfactory solution for the treatment of sight deposits and would reduced capital volatility.

  The IASB was not convinced by the proposal and purely regards IRHM as a version of cash-flow hedging, rather than a third hedging model. The IASB would only be prepared to consider the gains or losses as components of capital rather than profit adjustment items.

- As for applicability of the fair value option, opinions vary. Regulators are against applying the fair value option to own debts, saying that this might result in a profit increase even though the company's creditworthiness deteriorates. This "advantage", however, is unlikely in banking, given that the Basel Committee has already decided that valuation gains or losses cannot be recognised in determining the regulatory capital. Regulators also raised that the fair value option prejudices the comparability and reliability of accounting figures, because it allows a subjective valuation, making Profit and Loss Accounts volatile due to short-term money market volatility.

In contrast to regulatory opinions, European banks favour a wide application of the fair value option, for both theoretical and practical considerations. The current option to use fair value accounting for all financial instruments that meet the conditions is useful for banks, as it helps recognise hedging transactions according to their economic contents. Therefore, contrary to the IASB's revision proposal the FBE supports retaining the current regulation and is opposed to any further restricting of the FVO compared to the current proposal.

The financial sector regards the fair value option and hedge accounting as important instruments. The FBE aims to find an early solution that is acceptable for all parties and to finalise all pending issues by end-2005.

XBRL[11] and implementation of a uniform reporting system within the EU

The FBE supports the implementation and a uniform application of the XBRL reporting system within the EU. XBRL would primarily support the compilation of annual financial reports in a uniform structure and will allow a more standardised, efficient and cost-saving way of information collecting and processing and faster information flows.

The XBRL system is now being assessed in several European countries, some have launched development projects for its implementation. Although there are no coordinated development activities between EU member states as yet, the issue is now being addressed by EUROSTAT and the CEBS. In addition to standardising business reporting, the system would also support information collection by regulators.

The FBE set up a working group to coordinate XBRL tasks. According to the report submitted by the working group, switching over to the new system at the individual bank level is untimely and a gradual and slow transition is recommended. The working group proposes that the system should be presented to market players and then XBRL jurisdictions should be set up in the individual countries or by certain reporting units.

A working group on financial reporting was set up within the CEBS to develop a standard Balance Sheet and Profit and Loss Account format to ensure harmonious and uniform reporting. This format would be used for supervisory reporting purposes within the EU. The process of adoption of the proposed reporting format is now in progress, the FBE's specialists are involved in developing the final version.

At the CEBS's initiative, a project was launched at the beginning of 2005 to compile a Basel II capital requirements reporting system based on XBRL. The project is managed by the Central Bank of Spain, supervisors as well as banking specialists are involved in the work.

3. Fiscal Committee

The FBE Fiscal Committee reviewed the reporting requirements provided in the Directive on taxation of savings income in the form of interest payments (Directive 2003/48/EC) and the issue of VAT on financial services.

- Technical details related to the taxation of savings are addressed by a special working group within the FBE Fiscal Committee. With the contribution of this working group, a report has been compiled on official IDs and codes used for client identification in EU

[11] eXtensible Business Reporting Language

member states and in some non-EU countries (third European countries). The report is intended to serve as an aide for interest income payers in meeting their reporting requirements effective from July 1, 2005. Apart from this summary report providing a list of the IDs required, responding to requests from member states the FBE solicited information on measures related to the taxation of savings in member states. The legal framework for keeping track of interest income and for the transfer of information are in place in most member states and the relevant guides are now being prepared. A summary report on the status in the individual member states was sent by the FBE to all members. We forwarded the report to the Ministry of Finance.

- VAT on banking services (and particularly, on imported cross-border services) was an issue regularly addressed at the Fiscal Committee's meetings. The FBE's delegates gave a presentation on this issue at the conference on VAT on financial services, held in December in Dublin. The conference was attended by national tax authorities, government representatives and business professionals. In its presentation, the FBE emphasised that intensifying competition inside and outside Europe poses the need for quality and efficiency improvements and cost reduction in the financial services market. Traditional banking services are being increasingly replaced by hi-tech electronic products and services. Non-deductable VAT charged on parent company-to-branch, branch-to-branch and cross-border services is a huge cost factor, reducing profits. The time has come for the Sixth VAT Directive of 1997 to be recast. The definition of financial services in the Directive is obsolete and does not satisfy today's requirements: the distinction between taxable and non-taxable income is not clear enough and the deductable input VAT method, applicable within the EU, is missing. The legislation in its present form is complicated and causes legal uncertainties, its implementation involves high costs and it distorts competition. VAT has become a major barrier to the integration of activities aimed at efficiency improvement. The FBE urges a revision of the Sixth VAT Directive.

In 2004 the OECD Fiscal Committee introduced some new provisions that also affect bank information. Under the new measures, information held by banks may be used for tax purposes under information exchange between national authorities. The main changes relate to Article 26 of the OECD Model Tax Convention:

- According to the new provisions, the contacted party may not decline to supply information on the grounds that such information is not needed for its own tax purposes. This change makes it clear that a contracted state must supply information even if such information is not needed by that state for its own tax purposes.
- A new paragraph (Paragraph 5) was enacted to ensure that the supply of information relating to ownership interests or information held by a bank, other financial institution, agent or fiduciary, cannot be declined on the grounds that such information constitutes a bank secret.
- The secrecy provisions in Article 26 have also changed: information supply to supervisory authorities is permitted. A supervisory authority is the authority that oversees tax administration and compliance and is part of the administrative organisations of government in the contracted countries.

4. European Payment Council (EPC)

The European Payment Council in October 2004 elected Ágnes Lázár (Hungarian Foreign Trade Bank) to represent the Hungarian banking industry in the EPC. Hungarian Foreign Trade bank was nominated by the Payment System Council, the supreme body of the Payment System Forum, to

represent the interests of Hungarian banking in the EPC and to provide regular information on activities affecting payments in Hungary.

ANNEX

Board Meeting Agendas 2004

January 19, 2004	1. Proposal for revision of the Rules of the Hungarian Banking Association 2. Briefing on the HUF 100 billion EU Accession Agricultural Loan Scheme 3. Briefing on a joint letter by the Association of Securities Dealers, the Budapest Stock Exchange and the Hungarian Banking Association to the Minister of Finance 4. Proposal for the Association's working programme for the first half of 2004. 5. Miscellaneous
February 9, 2004	1. Report on the work aimed at developing a proposal for a new membership fee system 2. Amendments to the provisions on mandatory reserves of the Act on the National Bank of Hungary 3. Miscellaneous
March 1, 2004	1. Report on 2003 activities of the Hungarian Banking Association (Document for the General Meeting) 2. Proposal for a new membership fee scheme (Document for the General Meeting) 3. Report on the financial management of the Hungarian Banking Association in 2003 (Document for the General Meeting) 4. Proposal for the 2004 budget of the Hungarian Banking Association (Document for the General Meeting) 5. Proposals for resolving issues related to local trade tax 6. Miscellaneous
April 5, 2004	1. Preparations for the Association's Board Meeting of April 23, 2004 (verbal) 2. Report on 2003 Activities of the Hungarian Banking Association (Document for the General Meeting) 3. Main tasks for the Hungarian Banking Association in 2004 (Document for the General Meeting) 4. Proposal for a new membership fee scheme for the Hungarian (Document for the General Meeting) 5. Report on the Financial Management of the Hungarian Banking Association in 2003 (Document for the General Meeting) 6. Proposal for the 2004 Budget of the Hungarian Banking Association (Document for the General Meeting) 7. Proposal for new Rules for the Hungarian Banking Association (Document for the Annual General Meeting) 8. Miscellaneous

May 10, 2004	1. Briefing on the first meeting in 2004 of the FBE Financial Markets Committee 2. Meeting the Press 3. Miscellaneous
June 14, 2004	1. Report to the Board on the proposed new EU Capital Adequacy Directive and the impact study conducted by PricewaterhouseCoopers 2. Response letter to the Ombudsman's report on banks' mortgage lending practices (draft) 3. Report on the financing of Association publications and studies ordered by the Association in 2003 and 2004 4. Miscellaneous
September 7, 2004	1. Report on finalisation of the new capital requirements, June document of the Basel Committee and July document of the European Commissions 2. Proposal for the concept of the Insolvency Act 3. Briefing on the Hungarian Bank Card Forum 4. Professional activities of the Hungarian Banking Association in the second quarter of 2004 5. Miscellaneous
November 8, 2004	1. Proposal for improvements to the central credit information system 2. Briefing on the transformation of the National Deposit Insurance Fund 3. Proposal for a cooperation agreement between the Hungarian Banking Association and the National Police Headquarters 4. Briefing on the October 28-29 Budapest meeting of the FBE Banking Supervision Committee 5. Briefing on the October 17-18 Amsterdam meeting of the FBE Financial Markets Committee 6. Actions to improve banks' consumer image 7. Miscellaneous
GENERAL MEETING	
April 23, 2004.	Agenda: 1. Report on 2003 activities of the Hungarian Banking Association 2. Main tasks for the Hungarian Banking Association in 2004 3. Report on the financial management of the Hungarian Banking Association in 2003 4. Proposal for the 2004 budget of the Hungarian Banking Association 5. Proposal for a new membership fee scheme for the Hungarian Banking Association 6. Proposal for the Hungarian Banking Association's new Rules 7. Election of Ethics Committee members and a Board member 8. Miscellaneous

DRAFT RESOLUTION

The General Meeting adopts the Report on 2004 Activities of the Hungarian Banking Association.

Budapest, April 12, 2005

Dr Rezső Nyers