



**HUNGARIAN BANKING ASSOCIATION**

***REPORT***

***ON 2006 ACTIVITIES OF THE HUNGARIAN  
BANKING ASSOCIATION***

***BUDAPEST, APRIL 2007***

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## INTRODUCTION

The Hungarian economy has deviated from a sustainable growth path since the beginning of the new century. This was primarily due to the excessive increase in expenditures of the budget. With great efforts, the increase in demand had to some degree been brought under control and an investment and export-driven growth restored by 2005. However, there was no turnaround in stabilising the economy and restoring credibility. While the deficit was only modestly reduced, constraints have increased, the budgetary accounts have become less transparent, and quasi-fiscal transactions have increased.

Starting out from the premise that there was not enough time left in that parliamentary cycle to start major reforms, the government announced its 100 Steps Programme in 2005. This provided a, risky, chance for moving away from a standstill. Although most proposals and decisions taken under this programme were rational (eliminating the shadow economy, boosting activity, a step-by-step introduction of insurance elements to health care, transforming the family support system, taking the first cautious steps towards taxing capital incomes, etc.), they could not fundamentally change the macroeconomic situation, while the 100-day programme glossed over the seriousness of the situation.

The significant general government deficit and the persistently high financing needs of the economy clearly indicated that the general government system did not work efficiently, the budget savings tools applied were ineffective from the point of view of restoring equilibrium.

The debt to GDP ratio has been increasing for years, due to the high budget deficit relative to the inflation rate, the interest rates and the GDP growth rate. The increase in budget deficit is mainly due to the structural problems of the economy:

- The raising of the retirement age after 1990 failed providing a sustainable solution for the fundamental problems of the pension system. With the current worker to dependant ratio, the budget deficit will continue to grow.
- The public sector wage increase of 2002 was excessive, with no real basis in the actual financial conditions pertaining.
- The funding needs of the health care system are increasing (and so does the budget deficit), while the state of health of the insured is deteriorating.
- A subsidised education system should contribute to promoting the competitiveness of individuals and the country. One of the reasons for the low employment rates in certain regions of Hungary is the shortage of skilled workers, whereas degrees (in many cases multiple degrees) are obtained in the higher education system, which do not substantially improve labour market chances.

The Hungarian Banking Association in recent years has on several occasions over the past years warned that the financial equilibrium of the Hungarian economy was severely deteriorating and should be re-established through well-considered and resolute measures, to consolidate general government and, in a broader sense, to restore the credibility of economic policy. To achieve this, we proposed that the chapter on the implementation of the budget of the Public Finance Act should be reinforced, to enforce budget management that is stringent and observes guidelines. Furthermore, it would be warranted to undertake a comprehensive review of all sub-systems of general government and of the institutions operated by them to assess their efficiency and introduce a set of performance measurement

criteria. These are the measures that could lay the foundations for structural reforms, including, inter alia, the transformation of the tasking and financing of local government, alongside with administrative structures. We also emphasised that the revenue generating capability of the budget should be improved through broadening the base of taxes and contributions, while gradually reducing tax rates. The rate of budget expenditures relative to GDP should be reduced and the number and tasks of public institutions rationalised.

Returning to a sustainable growth path requires a comprehensive reform of the main subsystems of general government, the resumption of general government reforms that cannot be delayed any longer in the areas of health care, the pension system, public transport financing, the local government system, public services, etc. To successfully implement these reforms (which will require sacrifices in the short-term), it is essential to have purposeful cooperation at the political level spanning several parliamentary cycles, with a will to compromise.

Therefore, at the beginning of 2006, the Association proposed that all political forces recognising their responsibility for Hungary's development agree without delay on the key issues related to the administrative system, the local government system, health care, future tax levels and structures and the education strategy and then, following the parliamentary elections, the government start developing the details and implementing the changes. Some degree of social and professional consensus on the above issues can be and should be reached: the Hungarian Banking Association is always available to provide professional support for this.

What was the most worrying, beyond the ever-increasing constraints, which are constantly narrowing the government's room for manoeuvre, was the weakening of credibility in both fiscal and monetary policies. Along with launching budgetary consolidation as soon as possible, a must for a balanced development was the pursuit of a monetary policy that promotes the implementation of budgetary reforms, the harmonisation of fiscal and monetary policies and the restoration of their credibility.

The banking community supports early entry into the Euro-zone, within a reasonable and achievable time. This is also a pressure to improve the credibility of economic policy, and recognition of the need for economic policy adjustments to ensure a sustainable economic development.

Under a proper expenditure structure and a lower rate of distribution, a faster convergence does not necessarily mean a lower economic growth rate; on the contrary: if properly implemented, it will increase economic output through stability, positive expectations, competitiveness and increasing investments. Good examples of this are some EU member states that previously were on the periphery and today are members of the Euro-zone. In today's global economic framework, the reconciliation of fiscal and monetary policies, leveraging each other, is increasingly important and will be a prerequisite for creating the conditions for the introduction of the Euro. For these conditions to be sustainable, monetary and fiscal policies must be properly coordinated.

By the beginning of 2006 it had become clear that measures to re-establish equilibrium must be implemented in the weeks or months following the parliamentary elections. To handle the problems accumulated over years, the government developed its New Equilibrium programme. The Association regarded this programme as a starting package

required for re-establishing equilibrium and meeting the commitments of Hungary's convergence programme. While agreeing with the objective of the Programme, we were of the opinion that the tools designed to achieve this goal were inadequate and, in some of their elements, unsuitable. The announced plans only provided for short-term measures, whose structure was also questionable. Some of the measures were not adequately founded and the size of budgetary adjustment that would result from the envisaged measures could not be assessed; the most important elements of financial stabilisation, structural reforms, were missing from the program.

Although the austerity package announced was larger than expected, its structure prompted disappointment. The measures affecting the revenue side were excessive compared to those affecting the expenditure side. Further increasing the burden on the narrow group of taxpayers carrying most of the tax burden may lead to more tax avoidance and a further decline in employment.

Apart from the cut of consumer price subsidies, adjustments to the expenditure side are marginal and fail to address the structural processes causing the regeneration of the deficit.

It seems that the Government's concept for the reform of the pension system, health care and education is not yet developed; the HUF 30 billion savings to be achieved through the merger of government institutions are negligible relative to the overall adjustment required.

International experience shows that adjustments based on revenue increase cannot be successful in the long-term, because with the high and uneven tax charges, the package would normally be softened as elections approach. Nearly 70% of the withdrawals affect the incomes of households. Withdrawals, for the most part, would result in a decline in savings rather than in any reduced consumption.

Major items affecting the corporate sector include the upholding of the lump sum health care contribution, the introduction of a 4% solidarity tax and the postponement of a planned 5 percentage-point reduction in employer's social insurance contribution. However, the indirect impacts on the sector are even greater due to the ever-increasing expected capital costs in an unpredictable financial and regulatory environment, and the fall in domestic demand.

The government's stabilisation package will have a negative impact on household consumption and corporate investments. This will entail a slowdown in economic growth. The rate of this slowdown will depend, inter alia, on the available borrowing opportunities. All this may lead to an adverse situation with growing inflation and rising domestic interest rates.

The question is at what growth sacrifice the main objective of sustainable equilibrium improvement can be achieved.

The planned deficit cut was 4% of the GDP for 2006 and 3% for 2007 on annual basis. According to the government's plans, 50% of this deficit cut is to come from expenditure cuts and 50% from tax increases; however, thus far, tax increases have made up the greater part. The yields of the programme "government should start with themselves" came entirely from the sale of government buildings. Savings in 2007 and 2008 should come from cuts in administrative expenditures and from restructuring; however, the preparations

and legal conditions are not all in place yet. An element of the equilibrium improvement package was the freezing of budget reserves in 2006. This, as experience shows, largely means shifting the financial consequences of current year decisions to the next year ("soft savings"). Another important element of the package was the increase in energy prices. Gas prices rose by 30 per cent on average, electricity prices by 10 to 14 per cent. The rest of the items - except for a HUF 40-billion cut in the Medicines Fund - are mainly taxes. These mostly affect households, but some of them put significant burdens on businesses, as well. In their nature, the changes are basically focused on revenue-raising measures; reforms that would ensure that the savings are recurrent, are yet uncertain.

## **THE ECONOMY AND THE BANKING SECTOR IN 2006**

In 2006 the GDP grew at approximately the same rate as in the previous year (approx. 3.9%). Within domestic absorption, consumption grew nearly at the same pace as in 2005, investments slowed. The balance of trade improved due to favourable external conditions and export growth. Consumer prices were primarily influenced by energy prices and the increase in VAT; accordingly, inflation rose in the last months of the year and was 3.9% on an annual average basis. The exchange rate of the Hungarian currency weakened by 10% in the second half of 2006, to strengthen again by the beginning of 2007 to the level it has been at (with slight fluctuations) for nine years. Net earnings grew by 7.7%, in real terms at a rate similar to that of the GDP.

The economic activity rate remained low (55.3%), the rate of unemployment rose by 0.3 percentage points over the previous year, to 7.5%.

The deficit of general government was 9.6% in 2006. This was partly due to a higher-than-planned increase in certain expenditure items (medicine subsidies, pension expenditures) and partly to exogenous factors (increase in imported gas prices, the weak exchange rate of the Hungarian currency).

### **Performance of the banking sector in 2006**

The number of business banks rose from 34 to 37, but the overall number of credit institutions decreased due to mergers in the savings co-operatives sector. Some financial enterprises were transformed into credit institutions, branches of foreign-based credit institutions were established and new financial institutions were also founded in 2006.

Hungary's rate of 3 to 4 banks per million people is a good average by international standards, a moderate concentration ratio, as also shown by other indicators. The top seven banks (OTP, K&H, MKB, Erste, CIB, Raiffeisen, UniCredit,) account for 70% of aggregate total assets in the banking sector. With a value below 1000, the Herfindahl index (the sum of the squares of the market shares - in terms of total loans or total assets - of each individual bank, multiplied by 10000) has reflected a moderate concentration for quite some time.

The depth of financial intermediation continued to grow in 2006. The ratio of total assets to GDP rose from close to 60% in 2002 to nearly 90% in 2006. The loans-to-GDP ratio (non-financial enterprises + households) grew from 26% in 2002 to 43% in 2006 (the 2006 GDP figures are estimates). The depth of financial intermediation continues to lag behind that in Western Europe and other Central East European countries (Estonia, Latvia, Slovenia).

The capital strength of commercial banks virtually doubled between 2002 and 2006 (from HUF 888 billion to HUF 1,819 billion), growing by 20% in 2006. Aggregate equity in the banking sector increased by 40% in four years in real terms, with total assets rising by 70% in real terms and loans by nearly 90%.

As opposed to earlier years, the number of employees in the banking sector rose steadily in the past few years due to network expansions and the development of retail banking



operations. Staff numbers grew by 8% in 2006. The loans-per-employee ratio grew by 63% in real terms, greatly contributing to the increase in profitability in 2006.

Banks' capital adequacy (equity + subordinated loan capital), or more precisely: the ratio of banks' capital to risk-weighted assets is indicated by the solvency ratio. Banks' aggregate capital adequacy ratio continued to be well above the statutory 8% limit, although the difference between the statutory and the actual capital adequacy ratios was smaller in the case of large banks. With a minimum capital requirement of HUF 2 billion, smaller banks were not able to exploit lending opportunities; accordingly, they had a high solvency ratio and a low profitability rate. The solvency ratio of large banks was 9.8%, that of medium-sized banks 17.1% and that of small banks 21.9% in 2006 (ranking by ROE was just the opposite).

#### Aggregate figures of the banking sector

	2002	2003	2004	2005	2006
Number of banks	39	36	35	34	37
Equity (HUF billion)	888	1071	1262	1433	1819
Total assets (HUF billion)	10196	12861	14912	17559	20838
Solvency ratio	12,2	11,1	11,6	12,0	11,3
Number of employees	26947	27163	27190	28826	31227

Large corporate loans increased by 44% between 2002 and 2006, at a rate barely exceeding the GDP growth rate at current prices. This means that large corporate had developed the desirable financing structures by 2002 and subsequently have only increased their borrowings in proportion to the increase in their outputs, assets and capital. Surveys reveal that most large corporate in Hungary, including banks, are foreign-owned, about half of their borrowings are from Hungarian banks, the other half from foreign banks (such as the financing banks of their parent banks in their home countries). Consequently, large corporate borrowings from Hungarian banks are not expected to significantly exceed the GDP growth rate at current prices, although this cannot be ruled out in the event of a further shift in the corporate structure (due to the increase in the share of credit-intensive sectors).

SME loans grew by 124% between 2002 and 2006. This rapid growth resulted in a major shift in the share of SME borrowings in total non-financial corporate borrowings, from 43% in 2002 to 54% in 2006. However, there was a dual phenomenon underlying this growth: while some SMEs grew dynamically and increased their borrowings, the number of SMEs with no bank finance is still high; accordingly it is difficult to tell how borrowings in this sector will develop. Access to loans was promoted by banks adopting simplified credit rating procedures. This resulted in a significant growth. However, the share of SMEs in total corporate borrowings (54% in 2005) did not grow further in 2006: it may well be that as long as their economic activity rates fail to improve, their borrowing dynamics will

follow the GDP growth rate at current prices. A 10-percentage-point improvement in the current, 55%, economic activity rate (which would still be far from the economic activity rates in the Nordic States or in the United States) could significantly boost employment and borrowing demand in the SME sector.

Retail loans grew faster than corporate loans between 2002 and 2006. The stock of corporate loans in 2006 was close to 180% of that in 2002, the stock of retail loans 360% of that in 2002, in other words: retail loans grew twice as fast as corporate loans. Within retail loans, home loans grew nearly by the same rate. Home loans rose 3.65 times, non-home loans 3.49 times between 2002 and 2006 (although not concurrently within the four year period). Home loans doubled in a single year (in 2003) and then only doubled again during the next three years. This slowdown was due to two factors: tightening of the conditions for home subsidies and saturation of the market. Foreign currency-based loans with low interest rates were increasingly popular (notwithstanding the exchange rate risk); the stock of home loans borrowed in HUF decreased in nominal terms in 2006, the increase in home loans came from the increase in foreign currency-based borrowings (typically CHF).

The other component of retail loans is non-home loans. Non-home loans grew at a slower pace during the home loan boom of 2003. With this subsiding, their growth accelerated and was 50% each in 2005 and 2006. Foreign currency loans, and in particular, consumer mortgage loans were increasingly popular.

Borrowing in foreign currency is not unique for Hungary. A similar trend can be observed in other countries, such as Poland. Roughly a quarter of all loans were foreign-currency denominated in 2002; their share had grown to close to 50% of all loans by 2006. If this rate continues, then HUF loans will be abandoned roughly at the same time as Hungary joins to the euro zone.

The quality of assets remained steady in 2006 and even improved somewhat. Substandard, doubtful and bad loans accounted for 1.9% of all loans, and this ratio did not rise despite the rapid increase in SME, home and consumer loans. Although the exchange rate of the forint fell by more than 10% for a few months in 2006, the quality of assets improved by 0.2 percentage points, the share of substandard, doubtful and bad loans in classified loans was 1.5%.

### Main indicators of banks' assets

	2002	2003	2004	2005	2006
Loan to non-financial corporations Large corporate (HUF billion)	1882	2245	2387	2438	2703
Loan to non-financial corporations SMEs (HUF billion)	1402	1786	2226	2798	3138
Retail home loans (HUF billion)	697	1393	1775	2139	2545
Non-home retail loans (HUF billion)	507	607	822	1232	1767
Share of foreign currency loans in total loans to non-financial corporations and households (%)	26.4	28.9	33.7	41.7	47.1
Share of substandard + doubtful + bad loans in classified loans, average (%)	3.7	1.7	1.9	1.7	1.5

#### *Banks' performance was characterised by the following:*

Net interest margin decreased in the past few years, its ratio to total assets fell by 0.1 per cent each in 2005 and 2006. This decrease is not negligible, given that total assets are more than ten times the equity: a 0.1% drop in net interest margin leads to a more than 1% drop in ROE. The 4% in net interest margin attained in 2006 is high by international standards, but declining in trend. This, relatively high, net interest margin was, and is, influenced by at least four factors:

- The interest margins on retail loans are always higher than those on corporate loans; accordingly a higher increase in home loans in itself results in an increase in net interest margin.
- The loans-to-GDP ratio has an opposite impact: for any increase in product sales, lower prices are needed, and this holds true for loans.
- The doubling of foreign currency loans led to a decrease in net interest margin.
- The increase in loans exceeded the increase in total assets, what resulted in a slight increase in net interest margin.

Overall, a further erosion of net interest margin is expected.

Non-interest income consists of several elements. The public perception that banks have substantially increased their fees is wrong: the ratio of non-interest income to total assets decreased by 0.2 percentage points in 2006.

Banks were able to improve their cost management, operating expenses fell steadily, at an annual rate of 0.2 to 0.4 percentage points between 2002 and 2006.

ROE, according to preliminary data, decreased in 2006. This was mainly due to the slower increase in retail borrowings due to stabilisation measures and the increase in taxes imposed on credit institutions.

**Banks' profitability**

%

	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>
Net interest income to total assets	4.00	3.90	4.00	3.80	3.70
Non-interest income to total assets	1.10	1.30	1.40	1.40	1.20
Operating costs to total assets	3.60	3.40	3.00	2.90	2.70
ROE (after tax)	15.5	17.8	23.6	23.3	22.3

## **II. PROFESSIONAL ISSUES**

### **1. Adoption of EU financial legislation**

#### **1.1 Ministry of Finance proposal for legislation related to CRD<sup>1</sup> implementation**

The Ministry of Finance in April submitted to Government a proposal titled "Amendments to the Regulation on Capital Adequacy of Credit Institutions and Financial Enterprises". In this, the Ministry proposed that, contrary to the provisions of Government Decree No. 1036/2004 (IV.27) on adoption of the directives the Capital Requirements Directive be adopted before its official promulgation. The submission specified the laws and regulations affected and provided for a revision of the related legal framework, particularly the relevant provisions of the Civil Code and the Bankruptcy Law. It also presented how the Ministry proposed to exercise the national and supervisory discretions set in the Directive. The government endorsed the Ministry's proposal and the Ministry started drafting the legislation.

The Association fully supported early adoption of the Capital Requirements Directive. We emphasised that in addition to those laws and regulations specified by the Ministry, adoption of the CRD will require revisions to the accounting laws and the regulations on data protection and public finances. In relation to national discretions we pointed out the need for wide and detailed consultations.

#### **1.2 Legislation related to CRD implementation and the proposed Government Decree on credit risk management**

The drafting of legislation required for CRD transposition was substantially delayed, both compared to the planned schedule and the EU requirements. Apart from the proposed amendments to the Credit Institutions Act, only the proposed Government Decrees on the standardised and IRB approaches and on credit risk mitigation were furnished in 2006.

The drafts received contained a lot of mistakes, translation errors, unclear and unintelligible provisions, undefined terms and some inconsistently used terms. In addition to wording corrections, we proposed that an editing committee be set up with the involvement of specialists from the competent institutions (the Ministry of Finance, the Ministry of Justice, NBH, the Hungarian Financial Supervisory Authority, the Banking Association, etc). The Ministry of Finance rejected this proposal. Then, following a meeting between high-level officials, a detailed review of the draft texts was carried out in December.

In November 2006, the Ministry submitted to inter-ministerial review the draft law aimed at meeting law harmonisation requirements in relation to certain financial services. The proposal contained amendments to the Credit Institutions Act, the Capital Markets Act, the Act on the Hungarian Financial Supervisory Authority, the Act on Insurance and the Act on Building Societies. In view of the many objections and comments received (50 pages from the Hungarian Financial Supervisory Authority, 20 pages from the Association, 15 pages

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<sup>1</sup> Capital Requirements Directive

from the MNB), the proposal was revoked. The revised package is planned to be presented to Parliament in April 2007.

A prerequisite for adopting the proposed amendment to the Credit Institutions Act is the completion of the related implementation decrees. As for the proposed Government Decree on credit risk management, further consultations will be needed, especially regarding the provisions on credit risk mitigation. The proposals on operational risk, Pillar 2 and trading book are unknown yet and the proposal on securitisation is also planning to be issued in a second stage. Based on this, meeting the revised schedule for full implementation of the CRD in the first half of 2007 is doubtful.

### **1.3 Hungarian Financial Supervisory Authority - Validation Guideline**

Recognising that the delay in the legislation related to the CRD transposition makes it difficult for banks to prepare themselves, the Supervisory Authority drafted a Validation Guideline for the implementation, assessment and approval of the Internal Rating Based and the Advance Measurement Approaches (AMA), based on the CEBS Consultative Paper CP10. The drafters emphasised that the contents of the Manual may change subject to the official publication of the final text of the CRD and the regulations on its domestic implementation. The Draft Manual addresses in details the issues of cooperation between supervisors during the validation process, the approval process, the conditions for roll-out and permanent exemptions, the consideration of results in institutional processes (use test) and application practices (experience test). The Manual also addresses in details the various exposure categories, the definitions of default and loss, the quantification of risk parameters, the documentation of rating systems, data collection, the use of models purchased from external vendors and validation. The chapter on operational risk presents the validation of the simpler approaches, the capital requirements for investment firms, the validation of the AMA approach and the provisions for the partial use of the various operational risk measurement approaches.

### **1.4 Interbank database on operational risk to support CRD implementation**

Following the HBA Board's decision in 2005, work continued in 2006 for establishing a common interbank database on operational risk. Thirteen banks, together making up half of aggregate total assets in the Hungarian banking sector, joined the database until the end of the first quarter of 2007 (joining the data consortium is available to all members of the Association). The Hungarian Financial Supervisory Authority also supported the database, named HuNOR, by awarding HUF 7 million for the project under an application scheme for funds from supervisory fines.

The legal framework and the IT infrastructure were developed simultaneously. Membership contracts were signed during the summer and a decision-making body, made up of representatives from the Association and member banks, to manage issues related to the database was set up in September. The International Training Centre for Bankers managed the database project. The business specification and the tender documentation for IT implementation were completed in the first quarter of 2006. Under a two-round, closed tendering process, WIT-SYS Consulting Ltd. was selected to create the IT system for the database. Implementation went according to plans. After a testing period, in the second quarter of 2007, the system will be ready for receiving operational risk loss data online.

As a result of the specification process, a system capable of meeting central data processing requirements (collection of anonymous data, event storage, reports, inquiries) and providing a simple local data collection and data reading solution also for institutions that do not have operational risk data collection solutions in place.

## **2. Issues related to stabilisation and structural reforms**

### **2.1 Tax changes, the New Equilibrium programme**

At the beginning of June the Government presented the measures aimed at re-establishing budget equilibrium under its New Equilibrium programme. Some changes entered into force in September, others on January 1, 2007. The program provides for measures to improve budget equilibrium for the years 2006-2008: in addition to general government reform and reform of the local government system, it also envisages the transformation of the tax and contributions systems. General government and local government reforms are aimed at expenditure cutting, primarily through reducing the number of Ministries and curbing the operating expenses of administration and local governments and reducing the number of employees in the public sector.

The law imposing a minimum tax, or expected tax, on businesses was declared unconstitutional and annulled by the Constitutional Court at the beginning of 2007. The new draft law, correcting the objected provisions planning to be presented to Parliament in the second quarter of 2007. The Constitutional Court also annulled the law on petty cash tax, aimed at taxing unwarranted volumes of petty cash held by businesses. (Because the proposed new tax would have also applied to credit institutions, the Association had taken up the matter with the government and achieved that banks are excluded from the scope of the proposed legislation).

### **2.2 Tax on interest subsidies, special bank tax**

The Association was not involved in the drafting of the new tax laws and was taken by surprise to learn of the government's intention to uphold - contrary to earlier promises - the special tax imposed on banks, in the form of a tax on interest subsidies.

According to the Association's estimates, banks in 2005 and 2006 paid more than HUF 60 billion in special bank tax, justifying the Association's initiative of allowing banks to choose between being taxed based on their interest margin or their pre-tax profit.

Pursuant to the legislation effective from January 1, 2007, credit institutions are subject to pay a 5% tax on all interest and interest-type income from directly or indirectly subsidised loans, including interest subsidies received from the state. The Association expressed its view on several forums that the new tax was discriminative and unconstitutional, and rejected a selective treatment of the banking sector. Banks encountered a number of problems in implementing the new legislation; therefore, the Association turned to the Ministry of Finance for assistance in resolving the issues arisen.

### **2.3 Interest Tax**

The date of introduction of interest tax, originally stipulated in the legislation as January 1, 2007, was brought forward to September 1, 2006. Previously, the Association had had continuous consultations with the Ministry of Finance to ensure proper implementation of the Act. Since the rules in the government's New Equilibrium Programme did not correspond to those provided earlier, the Association initiated further consultations with the Ministry and proposed that the entry into force of the Act be restated as January 1, 2007.

The Association requested the Minister of Finance to intervene with the President of the Tax Authority to exercise due consideration with regard to the 45 days allowed for preparations and not to impose any fines for non-compliance with technical requirements in the period between September 1, 2006 and January 1, 2007.

To ensure simple and uniform implementation of the regulations on interest tax, we proposed enhancing KELER's KID securities accounting system. The enhanced system will be capable of storing and transferring more information during securities transfers between securities dealers. The Association of Securities Dealers also supported our initiative.

The taxation of foreign individuals is based on EU legislation and on individual agreements between the various countries; therefore, it requires special expertise. The Association commissioned the preparation of a summary of the relevant international tax laws. At the request of the Ministry of Finance, we made a proposal for the data contents of regulatory reporting on income tax on stock exchange transactions. Also, we carried out consultations on the contents of banks' Announcements in respect of interest tax.

### **2.4 Equilibrium package - Constitutional Court motion**

The Hungarian Banking Association, the National Federation of Savings Co-Operatives (OTSZ) and the National Interest-Representation Association of Savings Co-Operatives (TÉSZ) turned in a joint letter to the President of the Republic, requesting a preliminary constitutional control of the provision in the draft law on special bank tax and tax on interest subsidies and in the draft law on amendments to certain financial laws bringing forward the date of introduction of interest tax to September 1, 2006.

We presented our position that the tax on interest subsidised was unconstitutional, discriminative, violated the rule of law and legal certainty and was against the principle of general and proportionate sharing in taxation and against the EU legislation on taxation. We also argued that credit institutions would be subject to a multiple tax burden, given that the special bank tax was still payable until the end of 2006, in addition to the solidarity tax. Bringing forward the introduction of interest tax was against the requirement of legal certainty, since there was not sufficient time allowed for technical implementation between promulgation of the legislation and its entry into force.

The Constitutional Court rejected our motion under its Resolution No. 725/B/2006. According to this, the law package does change the taxation status of banks but this is not unconstitutional. In the Constitutional Court's practice, a change in the taxation status would only be unconstitutional if such change reduced or revoked, ahead of time, a tax allowance granted to the taxpayer for a definite period. According to the Constitutional



Court, the law is not discriminative, given that it equally applies to all credit institutions. The tax on interest subsidies is based on the assumption that these state subsidies fundamentally and significantly increase banks' profits.

## **2.5 Taxation and registration issues related to preliminary pension**

The Association organised a consultation for banks to review issues related to the management of preliminary pension savings accounts, where the relevant laws failed to provide clear-cut guidance. A key issue is the tracking of funds flows and securities movements in preliminary pension savings accounts and compliance with the related registration requirements. These pose the need for information exchange between transferor and recipient banks. Banks are of the opinion that the form and contents of this information exchange should be laid down in a standard documentation and it would also be expedient to provide for a common scheme for determining the valuation rates to be applied on the withdrawal of balances or transfer of balances between banks. Based on this consultation, a discussion aimed at developing standard procedures commenced.

## **2.6 Association proposals related to 2007 tax laws**

In relation to the legislation on personal income tax, we proposed that the provisions on interest income be made more specific to allow uniform interpretation: we pointed out that the divergent treatment of interest as income, (interest set in non-public contracts is treated as other income, not interest income), was wrong. We proposed that, as is the case with the rules applied to co-operatives, in addition to the requirement of publicity, the law be complemented with an interest cap, up to which interest is to be treated as income taxed separately rather than as income included in the consolidated tax base (and subject to other public dues).

We also proposed to specify the criterion evidencing that a deposit facility has been used for home purchase, given that the tax exemption not only applies to building society deposits but to all types of home savings deposits.

In relation to the Act on the Rules of Taxation we proposed to allow replacing the tax domicile certificate for foreign nationals by a statement (we provided a draft text for this statement). This would ensure that treaties on the avoidance of double taxation could be applied in a clear-cut manner, thus reducing foreign nationals' claims for tax refund from the tax authority. We requested to allow that interest adjustments are reported on a net basis in tax returns and tax payments. From 2007, the individual's social security number is to be stated in the tax reports on payments made to private individuals; we requested that in those cases where there is no social security relationship (such as gains on OTC transactions), the social security number be relinquished.

Furthermore, we proposed that the Act on Duties be amended in relation to financial leasing services for cars: the Act on duties does not require car dealers to solely engage in car sales, whereas companies providing financial leasing services for cars, may, by law, solely engage in financial leasing. Consequently, companies not solely engaging in financial leasing are, in respect of car leasing, disadvantaged to car dealers. We drafted and submitted to the Ministry of Finance an amendment to the Act to eliminate this discrimination.

## **2.7 Amendments to the Act on Bankruptcy, Liquidation and Voluntary Winding-Up**

In relation to Act VI of 2006 amending the current Bankruptcy Act, we contacted the Ministry of Justice, indicating that there was an incoherence in the closing provisions of the Act (drafted in the hectic year-end lawmaking campaign in 2005), that is: the provision on the entry into force of the charge regulations were not fully coherent. Furthermore, we indicated that the new paragraph h) under the order of satisfaction provided in Subsection 57 (1) of the Bankruptcy Act raised serious concerns: under this new paragraph, claims held by members, senior officers, etc. of the business organisation under liquidation are subordinated to all other claims. We indicated that this provision might be highly disadvantageous from the point of view of reorganisation and would deprive market players of important financing resources. We suggested that those claims specified under paragraph h) be confined to claims held by beneficiaries interlocked with the business organisation in question.

Out of the two problems raised, only the incoherence in the dates of entry into force was eliminated by legislation. Subsection (2) of Section 58 of Act LXIX of 2006 on European Co-Operatives, taking effect on August 1, 2006, has amended paragraph b) of subsection (1) of Section 57 of the Bankruptcy Act by allowing the satisfaction under paragraph b) not only of floating lien claims but of all charge rights instituted prior to the starting date of the liquidation procedure, including independent lien rights and claims aimed at satisfaction solely from the pledge. The solution to our proposal regarding the order of satisfaction of claims under paragraph h) is delayed: the draft law on measures aimed at promoting the legal certainty of transactions of business organisations is still under preparation at the Ministry of Justice. The Ministry promised to incorporate our proposal in this draft law.

The Association managed to avert a proposal for reinstating the previous 50% limit in place of the provision providing for a 100% satisfaction of lien holders' claims from January 1, 2007.

### **3. EU support schemes**

#### **3.1 Economic Development Programmes**

The Association formulated opinions on the government's various-level development programmes: the New Hungary Development Programme and the related 15 Operational Programmes. We underlined that the developing of the Economic Development Operational Programme (EDOP) was a major achievement. The relevant proposal consciously addressed the interrelations between the EDOP, the Convergence Programme and the National Action Programme (NAP) related to the Lisbon process; however, it failed to present the consistency between the EDOP and the NAP and that between the EDOP and the Convergence Programme. We emphasised that since the underlying problem was that while the state systems (the health care system, the pension system, the administrative, education and public transport systems) are overspending, employment is a, cumulative, problem in certain regions of the country; the government's efforts should be focused on these areas, projects under the Economic Development Operational Programme should be aimed at resolving these problems and progress should be measured by tangible indicators. For the disparities to be reduced, clear priorities should be set.

The New Hungary Programme is also notable from banking points of view: a well-considered income policy may add new resources and a restructured health care system may create new investment and lending opportunities. The various regions, as key development areas with specific profiles, will require more financial services than ever. All this suggests a strong economy and a growing banking sector in the medium and long-term.

For the economy to be competitive, human and physical resources should be available in the required numbers, structure and locations. Accordingly, we consider transport, training and health care as key areas to be developed.

Members of the SME Technical Group were actively involved in the review of the various operational programmes. Our proposals were mainly aimed at promoting the participation of SMEs in grant schemes and making the management of the programmes as simple and as transparent as possible.

### **3.2 SME financing**

The government adopted a resolution on further developing the *Széchenyi Card* scheme, amending certain conditions of the scheme and involving more banks in the scheme. As a result, basically a new product has been created. The maximum loan amount of HUF 10 million has been increased to HUF 25 million; however, cards over HUF 10 million are provided without state guarantee. 50% of the guarantee fee continues to be subsidised by the state. For cards over HUF 10 million banks may require real estate collateral.

At banks' request, the Association initiated with the Ministry of Finance to allow more banks to join the *Széchenyi Card* scheme. Six banks purchased the relevant tender, three of them, submitted bids. KA-VOSZ (a joint corporation of the National Organisation of Entrepreneurs and Employers - VOSZ and the Hungarian Chamber of Commerce and Industry - MKIK) is now negotiating with the two accepted bidders on the conditions for joining.

At the request of the Ministry of Economy and Transport, the Association drafted a proposal for relaxing and simplifying the collateral system. Banks say SMEs have excessively encumbered their collaterals under the various loan schemes and there is a concern that only a few of SMEs will be able to participate in new economic competitiveness schemes.

### **3.3 Agricultural loans**

At banks' initiative, the Association held a meeting with the Agricultural and Rural Development Office of the Ministry of Agriculture on the expected procedure for area-based aid in 2006. At the meeting, we were advised that the procedure for area-based aid was basically unchanged. No information was provided, however, on the amount of the aid.

The government decided to extend the repayment period for preferential loans granted to drought victims from five years to ten years. For the decision to be implemented, approval from the EU was required. Although the government approached the EU for approval in August 2005, the approval was received as late as April 2006. The drafting of the relevant Government Decree started only after that.

Due to this, an interim solution was required for banks to be able to defer the instalments due. Accordingly, in a letter to the banks, the Ministry of Agriculture and the Ministry of Finance confirmed that the interest subsidies and state guarantees will continue to be valid.

At the initiative of the Ministry of Agriculture, a consultation was held at the Association on pre-financing EU grants for *sugar beet growers*. The Ministry informed that the EU has adopted the appropriation for grants for sugar beet growers until 2013. The objective of the meeting was to develop a solution under which grants, provided over several years, could be prefinanced. Banks involved said this was possible provided certain conditions are met. The issues and proposals made were primarily related to mitigating risks.

At the request of the Sugar Beet Product Council, we drafted a proposal for an agreement to be signed between sugar beet growers and banks, primarily aimed at providing banks with information on applicants and beneficiaries of the loans.

#### **4. European Payments Council - SEPA**

Activities aimed at creating a Single Euro Payment Area (SEPA), a major project of the European banking industry, are in full gear. The European Payments Council (EPC) manages this complex programme of action based on self-regulation. Hungarian banks are represented in the EPC's managing body and working groups. The new system, fundamentally transforming Europe's payments landscape, is scheduled to be operational in January 2008. In the new system, main payment transactions in Europe (credit transfers, direct debits and card payments) will be managed under standard Pan-European Payment Schemes. The scheme rulebooks, standards and implementation guides are now ready; there is some delay in the legal and competition law frameworks.

The Payment System Forum and the Association coordinate activities in Hungary. Parallel with this, a national SEPA organisation will have to be set up. The competent government bodies will also have to be involved in the organisation; in this respect, some legal obstacles have arisen that need time to be resolved. Therefore, the Hungarian SEPA organisation has not been set up yet.

The Payment System Forum, the consultative body of the Association and Magyar Nemzeti Bank, continued to work actively in 2006. Representatives from member banks, the central bank and Giro Ltd. addressed current issues related to key areas of the payments system in the Forum's working groups and technical committees.

#### **5. Other professional issues**

##### **5.1 Association proposals for amendments to accounting rules**

###### **5.1.1 Delivery repo transactions**

The Association continued its consultations with the Ministry of Finance on the proposal for amending the rules for accounting for delivery repo and securities transactions with a view to convergence with the international practice.

The relevant accounting issues were discussed at several meetings with the Ministry. However, the end of 2006 had reached no solution. The ministry wanted to collect

information about international practices other than the IFRS<sup>2</sup>, such as the US GAAP and the Australian and Japanese accounting practices. The Association emphasised that Hungarian accounting rules should in the first place be adjusted to the IFRS, the financial reporting standards adopted by the EU; other standards, applied overseas, may only be considered afterwards, within the framework of global convergence.

As a result of the consultations, a method acceptable for the Ministry of Finance was developed; however, banks are of the opinion that this method is still not fully satisfactory.

### **5.1.2 Accrual of exchange rate losses on foreign currency loans**

At the Association's proposal, the rule on the accrual of exchange rate losses on foreign currency loans was reinstated. Accordingly, unrealised exchange rate losses on investment loans can now be accrued. This means that exchange rate loss on a foreign currency loan over the entire loan period of 10 to 15 years is no longer measured against a one-year revenue generated by the new investment in the accounting year: now it is the 1-year portion of the exchange rate loss that is to be reported in the profit/loss for the year. The reinstatement of this rule is favourable for businesses engaged in construction projects financed from foreign currency loans or purchasing production equipment or vehicles under foreign currency loans and then leasing them long-term on a foreign currency basis (and through these businesses, for banks, as well).

### **5.1.3 Amendments to the accounting rules for credit institutions**

In relation to the proposed amendments we welcomed the new rule for accounting for interest-type commissions, allowing for accruals pro rata of interest as an alternative to pro rata of time during the loan period; however, we drew attention to some problems experienced in respect of certain consumer loan products and requested that the regulation be adjusted accordingly. The Ministry adjusted the regulation as requested.

In relation to foreign currency interest rate swaps and foreign currency deposit swaps involving interest rate swaps we drew attention that the proposal needed fine-tuning due to the complexity of these transactions.

## **5.2 Regulatory reporting**

### **5.2.1 Central bank reporting**

The MNB announced that the central bank reporting system will be substantially revised after 2006. This was needed due to changes in the economic environment and in the international regulatory framework as well as the implementation of a new statistical data receipt system with higher security and data protection at the MNB. Changes in the reporting requirements were also needed due to ECB reporting requirements. The MNB regularly reports on Hungary's monetary data to the ECB. An important requirement in the EU is that the ECB is provided with harmonised and high quality statistical data so that it can successfully perform its monetary and other regulatory tasks.

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<sup>2</sup> IFRS: International Financial Reporting Standards

The industry was actively involved in the preparatory activities in 2006. Banks received regular information through the Association on the proposed methodology and technical changes. In relation to the development works the Association requested that the MNB, as far as possible, rely on the data contents and code tables of the current, well-established reporting system and avoid redundant data requirements.

To meet the ECB reporting requirements, new securities reports have been introduced from 2007. For the purpose of a Central Securities Database (CSDB) to be set up by the MNB, more details will be required to be reported on securities. New reports on payments, frauds in payment transactions and breakdowns in payments will also be introduced. Effective from 2007, all communications between MNB and reporting entities will be done through this new IT system, called EBEAD.

The balance of payments reporting system will be revised effective from January 1, 2008. The current, indirect, reporting system, which is based on the provision of transaction codes for cross-border payments and is mainly built on reports by credit institutions will be gradually replaced with a direct reporting system, where each reporting entity will report its own balance of payment-related transactions and balances directly to the central bank. Accordingly, banks' reporting requirements will significantly change: the volume of information to be monitored and reported will be reduced, but banks' IT systems will have to be modified to meet the new data requirements, in terms of both structure and contents.

From the end of 2006, banks have been directly involved in the methodology improvement work conducted at the ECB. The ECB would like to obtain more refined and more detailed information on corporate and retail transactions and interest rate statistics. The new methodology is aimed at assessing and classifying loans by purpose, coverage, loan amount and maturity. Credits associated with the use of credit cards will be analysed in depth in the future to better monitor the evolution of Euro interest rates in the Euro-zone.

### **5.2.2 2007 supervisory reporting requirements**

In relation to the proposed changes in the supervisory reporting requirements for 2007 we indicated that the regulatory capital reporting requirements should be updated in view of the new capital elements introduced under Act CLXXXVIII of 2005. Furthermore, we requested to make certain definitions more specific and adjust some tables in the reports.

We requested the Supervisory Authority to take into account that banks needed time to prepare themselves for the new regulatory requirements, promulgated at the very end of the year, just before the beginning of the new year; new IT development works were to be launched in time for banks to be able to meet the reporting requirements from the beginning of 2007. Based on the initial information we had on proposed changes in the calculation of supervisory fees, we indicated that these should be included in the reporting requirements.

### **5.3 Implementation of new rules for the central credit information system under the Credit Institutions Act**

In January 2006, the Association organised a consultation with the involvement of the Ministry of Finance, the Hungarian Financial Supervisory Authority and Interbank

Informatics Service Ltd. (BISZ Rt.) to review tasks related to the entry into force of new rules for the central credit information system in the Credit Institutions Act.

Customer information was given special attention at the meeting. The Hungarian Financial Supervisory Authority compiled a proposal for the practical implementation of customer information. The proposal was submitted for review prior to the meeting. Banks involved in the review were of the opinion that the Supervisory Authority had tried to find the solutions that would provide the highest possible safety regarding information provision, however, the pursuit of, excessive, safety resulted in some complicated solutions, which could be simplified. Banks' written proposals were forwarded to the Supervisory Authority's Consumer Protection Department; a number of these proposals were incorporated in the relevant supervisory recommendation

#### **5.4 Participation in the government working group set up to develop measures for the elimination chain debts**

Originally, the government proposed to amend the Public Procurement Act to eliminate chain debts. However, neither banks nor businesses in the construction industry (the most heavily impacted sector) agreed that imposing certain payment terms would help resolve the issue. It was also raised that chain debts in projects implemented without public procurement procedures should also be eliminated. Therefore, Parliament decided that the government should prepare and submit draft legislation on the issue by March 31, 2007.

The Ministry of Local Government and Regional Development, responsible for the construction sector, set up a working group to comprehensively review the issue under a set procedure and timetable. The Association was invited to participate in the working group. The Working Group is a useful forum for dispelling preconceptions regarding banks, and financial services, in general, and familiarising the public with role and importance of financial intermediaries.

#### **5.5 Issues related to land registration**

Land registration regulations have changed effective from January 1, 2006. (Act CXXII of 2005 amending the Act on Land Registration, Ministry of Agriculture Decree No. 117/2005. (XII19.) amending the Implementation Decree and Ministry of Agriculture Decree No. 118/2005 on administrative/service fees for land registration procedures). A number of interpretation and application issues arose in connection with the new regulations. After collecting the questions, we organised a consultation. At the consultation, issues related to the use of the new form and the method of fee payments were reviewed.

Following the consultation we turned to the National Housing and Construction Office (OLÉH) and to the Ministry of Finance for clarification concerning the definition of "home loans". Namely, the Act on Land Registration Fees provides for preference for the registration and deletion of mortgage and prohibition of alienation and encumbrance related to home loans. Some Land Offices had interpreted the legislation in such a way that this fee exemption is only applicable to subsidised loans. Upon our approach, the Ministry of Finance ruled that this, restricted, interpretation was wrong and the exemption should be applied to all housing loans (including foreign currency loans).

Issues raised by banks in connection with Land Office practices were collected by the Association and communicated to the Ministry of Agriculture in 2005. The Ministry answered the questions in February 2006.

### **5.6 Municipalities' pre-emption rights under the Act on Judicial Distrain**

An amendment to Act LIII of 1994 on Judicial Distrain, adopted at the end of 2005, granted the territorially competent municipality a pre-emption right in real estate distrain procedures. According to the law, the municipality may exercise its pre-emption right within 30 days after the auction, at the highest price quoted during the auction. According to the reasons of the law, giving the municipality a pre-emption right is aimed to ensure that housing mafia victims do not lose their apartments once and for all, because once the municipality exercises its pre-emption right, it can subsequently rent the apartment to the former owner. The amendment entered into force on January 9, 2006.

Because the draft law had not been submitted for administrative review, we could only give our objections after the legislation had entered into force. Given that the new regulation affects the wider financial community, the Hungarian Banking Association, the Hungarian Factoring Association, the Hungarian Mortgage Banks' Association, the National Association of Financial Enterprises and the National Interest-Representation Association of Savings Co-Operatives jointly turned to the Prime Minister, the Minister of Justice and the floor leaders of the governing parties.

In his response, the Minister of Justice acknowledged that the legislation should be amended. Given that distrain procedures are not suspended for any regulatory problems, jointly with the National Association of Financial Enterprises we asked for assistance from the National Association of Local Governments. At our request, the National Association of Local Governments on its website issued a circular drawing the attention of local governments to the regulatory problems in question and published a request by the Association and the National Association of Financial Enterprises that until the legislation is amended, municipalities help ease the situation by making an early announcement as to whether or not they intended to exercise their pre-emption rights.

### **5.7 Mortgage-based life annuity**

A Hungarian Actuarial Society gave its position on insurance risks and mortgage-based life annuity contracts. In its position, the Actuaries Association pointed out that content-wise, the provision of mortgage-based life annuity, as an activity, is similar to life insurance and so are the risks involved. Therefore, it would be reasonable for this activity to be subject to the same personal, technical and capital requirements as those applicable to insurance companies. In our response we indicated that we would support that this type of activity be pursued in a regulated and supervised manner under adequate guarantees that would also ensure the long-term interests of the customers. To our knowledge, the drafting of the respective regulation is now in progress at the Ministry of Finance and the Hungarian Financial Supervisory Authority.

### **5.8 Rules of procedure for the provision of state guarantees**

The Ministry of Finance sent us for review the proposed Government Decree on the preparation and redemption of state guarantees. The decree is related to a recent



amendment to the Act on Public Finances and includes additions and proposals made by the Government Control Office and the State Audit Office. Based on banks' opinions, we provided a number of comments on the draft. We expressed our objection to the provision requiring the beneficiary bank to verify the accomplishment of the loan objective. We also objected to the unnecessary extension of reporting obligations. Furthermore, we submitted comments aimed at making the provisions of the Decree and its Appendix more specific. We requested that a longer period be provided between the promulgation and entry into force of the Decree in order to give banks time to prepare themselves and revise their internal procedures.

### **5.9 Constitutional Court ruling**

The Association filed a motion with the Constitutional Court in March 2002, requesting the Court to declare certain provisions of Act CXVI of 2001 on the National Land Fund, amending the provisions of the law decree on expropriation, certain other provisions of the Act, certain provisions of the Act on Arable Land and certain provisions of the Government Decree on pre-emption rights and pre-emptive lease rights, the Government Decree on the registration of assets of the National Land Fund and the Government Resolution on Land Policy, unconstitutional.

The Constitutional Court issued a resolution in the matter on February 21, 2006. Pursuant to this, Subsection 8 (3) of the Act CXVI of 2001 on the National Land Fund and Paragraph 4 (1) p) of Law Decree 24 of 1976 on Expropriation were declared unconstitutional and annulled as of the date of the promulgation of the resolution. Our motions on the other subjects were turned down, partly due to the fact that the provisions in question had in the meantime been changed during amendments to the legislation.

### **5.10 Data Protection Ombudsman's position on data processing for direct marketing purposes**

The Data Protection Ombudsman issued a ruling in which he challenged banks' practices in processing data for direct marketing purposes. In the Ombudsman's opinion, pursuant to Subsection (5) of Section 201 of the Credit Institutions Act, banks may only send advertising material to those customers who specifically request for such materials. The Ombudsman bases his opinion on Section 14 of Act CVIII of 2001 on Electronic Commerce, which provides that electronic advertisements may only be sent with the prior consent of the user. In the Ombudsman's opinion the contradiction between the Credit Institutions Act and the Act on Electronic Commerce should be solved by adopting the provisions of the Electronic Commerce Act in the Credit Institutions Act.

In our letter to the Ombudsman we submitted that he did not give sufficient consideration to the specifics of the banking industry and to other regulations applicable to credit institutions and drew attention to the fact that the Direct Marketing Act was much more permissive in relation to other organisations, allowing them to send advertising materials by mail without any control or supervision at all. In our view the relationship between the Credit Institutions Act and the Electronic Commerce Act is one between general regulation and specific regulation. In his answer, the Ombudsman maintained his positions. Therefore, it seems that the issue can only be resolved through legislation.

### **5.11 Prompt collection based on forged court orders**

The National Investigation Office's Economic Protection Department in October 2006 contacted us, drawing our attention to a new type of crime: prompt collections initiated based on forged court orders. We alerted all member banks and received some useful proposals regarding the methods for preventing these crimes: in the short-term, court orders should be verified for genuineness and contents, in the long-term, the rules for prompt collection should be comprehensively reviewed. A summary on the proposals received was sent to legal counsels at our member banks.

We sent the proposals to the Ministry of Finance Ministry, the Ministry of Justice and the National Council of Justice. The Ministry of Justice did not rule out a revision of the legislation; however, no concrete steps have been made. Therefore, we have raised the issue again with the National Council of Justice and the Ministry of Justice.

### **5.12 Registration of prohibition of alienation and encumbrance in the Land Register**

We initiated with the Ministry of Finance an amendment to the regulations regarding this issue. The issue was that pursuant to the Act on Real Estate Registration, additional rights and facts, other than the rights and facts defined in this Act might be entered in real estate records only if so prescribed by law. Based on this provision, some Land Offices refused to enter the prohibition of alienation and encumbrance in favour of the Hungarian State, as required by Government Decree No. 12/2001 (I 31) on Home Subsidies.

We proposed that the entry of prohibition of alienation and encumbrance in favour of the Hungarian State, be stipulated in the Act on Public Finance. In response to our request, the Ministry of Finance included, in Act CXXI of 2006 on certain underlying laws for the 2007 Budget, a provision complementing Act XXXVIII of 1997 on Public Finance. The new provision, Subsection 209/L, provides that a mortgage in favour of the State shall be instituted, and, to secure it, a prohibition of alienation and encumbrance entered in the land register in relation to housing allowances, home building supports for young people and advance loans on such supports. The new provision is effective from January 1, 2007.

### **III. ASSOCIATION LIFE, EVENTS**

#### **1. Association conference on Basel II and the IFRS**

The Association organised a conference for member banks on the relationship between Basel II and the IFRS and on the current state of the Hungarian regulatory framework. The objective of the conference was to provide a forum for regulators, consultants and banks to exchange views and results and raise questions in the subject. Banks have started developing best practices and the technical conditions for compliance.

The head of the Financial Services Department of the Ministry of Finance gave a presentation on the objective of the CRD and the status of its transposition into Hungarian legislation. In their presentation on the relationship between Basel II and the IFRS, PricewaterhouseCoopers' specialists exposed a number of important issues to be addressed. There has been significant debate within the industry on the relationship between the rules for credit loss and write-offs in the IFRS and the rules for the calculation of capital requirements and provisioning for expected losses in Basel II. The presenters drew attention that although there are a lot of similarities between the requirements (and thus, the datasets to be used) in Basel II and the IFRS, one should not lose sight of the fact that the objectives of IFRS and Basel II are fundamentally different.

The Managing Director of the Economics, Risk Assessment and Regulatory Directorate of the Hungarian Financial Supervisory Authority presented the relationship between the supervisory reporting requirements of the CRD and the IFRS.

The Deputy Head of the Accounting Department of the Ministry of Finance spoke about the accounting assessment requirements, saying the framework for the accounting assessment of balance-sheet items will not change upon implementation of the CRD. A high level decision has been made that the IAS/IFRS standards cannot be applied to individual annual reports in Hungary for the time being.

#### **2. Consultation on adopting the EU customer information standards**

The Hungarian Competition Authority issued recommendations for the Association based on its investigation on the home lending market. The purpose of the recommendations is to improve customer information before borrowing. The Voluntary Code of Conduct on Pre-Contractual Information, applied by European banks for quite some time, could further promote this. The Ministry of Finance emphatically drew banks' and the Association's attention to this Code, which is also formally recommended by the EU. Partly based on these approaches, the Association's Board also offered the Code for consideration by member banks.

The Association organised a consultation for banks involved in home lending and requested the participants from FHB Land Credit and Mortgage Bank to present the Code ((FHB was to adopt the Code within short). At the consultation, banks were given a detailed overview of the implementation of the Code. During the consultation it was also mentioned that although some European banks are of the view that customer information in such depth is excessive and unnecessary, most banks find it useful and apply it in their daily practices. The voluntary

adoption of the Code also raises some questions (there are no sanctions for non-compliant banks); however, European banks believe the worst voluntary regulation is yet better than an imposed and stringently controlled authority regulation).

After further consultations on the issue, most banks involved in home lending indicated their intention to adopt the Code.

### **3. Meeting of the Parliamentary Committee on Law Enforcement and National Defence at the Association**

The issue of banks security continued to be high on the Association's agenda in 2006. Within this framework, the Association invited the Parliamentary Committee on Law Enforcement and National Defence to hold a meeting at the Association.

Members of Parliament heard presentations and detailed briefings on the overall situation of bank security in Hungary and internationally, physical security and electronic banking, internet mobile phone and card transactions security.

At the meeting, the Committee pledged to support the Association's specific proposals aimed at adjusting certain provisions of legislation affecting bank security (for example, the abolition of the offence of negligent money laundering).

## **4. Association working groups**

### **4.1 Communications Committee**

The Communications Committee reviewed key communications themes and main elements of the communications strategy in 2006. Members underlined the need for cooperation and mutual information. The Association held several new conferences and press meetings in 2006 to strengthen its relations with the press, to improve the social prestige of the banking community and dispel preconceptions.

Communications is given special emphasis in the Association's strategic plan for 2007-2012. The Committee reviewed the Associations 2007 communications plan. Key points of the 2007 plan include the combating of anti-bank sentiments, developing the norms of relationship between banks and customers, improving customer information, strengthening consumer protection and enhancing bank security.

### **4.2 Bank Security Committee**

The Association's Bank Security Committee was renewed at its meeting of December 7, 2006. Pursuant to the Organisational and Operational Rules adopted at the meeting, the Committee now has four working groups (as opposed to the former three). These are as follows:

- Compliance Working Group (money laundering and insider trading issues),
- Fraud Working Group,
- Physical Security Working Group,
- IT Security Working Group.

Peter Jakab, MKB Director for International Trade, was elected as leader of the Bank Security Working Group for an additional two-year term. The working groups will elect heads of the working groups. Invited, as a guest to the meeting was Professor Katalin Gönczöl, Chair of the National Crime Prevention Board at the Ministry of Justice, who attended a round-table discussion on current issues related to crime prevention strategy.

The meeting offered a good opportunity for dispelling misconceptions concerning any negative lobbying by banks: after the Mór robbery there was a determination to provide for bank security requirements in the form of legal regulation; this did not materialise, but it was not an alleged resistance by banks that has prevented it: the security standards developed at that time have been applied by banks without any imposed legal obligation ever since. The meeting also highlighted to the National Crime Prevention Board the conflicts between the interests of security service providers and their clients. Katalin Gönczöl emphasised the need for dialogue and invited the banking profession to be represented on the National Crime Prevention Board.

The IT Security Working Group addresses issues related to enhancing security in electronic payments. In addition to phishing, a new type of fraud, pharming has appeared: this redirects the user to a fake website even where it is not a popular or frequented website where the user selects the target from, but a specific URL address; when entering the URL address, the user is redirected, through a Trojan program, to a fraudulent website instead of the intended website.

Attacks are increasingly organised; therefore, cooperation between banks' security specialists is crucial for combating this type of fraud. The Police, security experts and Hungarian institutions with international contacts should also be involved in these efforts. With the rapid development of information technology, banks are today capable of offering an ever-increasing range of electronic banking services, allowing customers to choose the ones that best fit their requirements.

### **4.3 Fraud meetings**

Complementing operations of the various working groups of the Bank Security Committee, Fraud Meetings are organised by banks' card security officers on a monthly basis. At these meetings, always held at a different bank, participants exchange information on bankcard frauds committed in other countries, particularly in ATMs or POS networks. Such information exchange can help specialists in preparing themselves and taking measures to prevent similar cases in Hungary.

## **5. Bank Card Forum**

Discussions were continued in 2006 to decide on whether to renew the VISA and MasterCard forums or to maintain the Bank Card Forum, as a single organisation (although with more stringent rules), where participants can discuss problems and development issues of the profession. In March, Csaba Braun was elected to replace Éva Szarka Dudás as leader of the Bank Card Forum. By the end of the year it had appeared clear that most banks would opt for a single organisation, a Bank Card Forum, to be governed by a set of more precisely defined and set rules.

## **6. International seminar on the Law of Proprietary Security Rights in the Proposal for a new Hungarian Civil Code**

The Ministry of Justice in November organised a 3-day seminar on the proprietary security law chapters of the proposed new Civil Code. The seminar was attended by prominent Hungarian and international experts. Alongside with other organisations, the Association provided financial sponsorship for the event.

Legal counsels also attended the seminar from member banks. Solutions provided by the proposed legislation were reviewed at a meeting with the drafters of the legislation prior to the seminar.

Banks raised some major concerns. They objected to the fact that the new Civil Code would prohibit the use in contractual relationships of collaterals that are not in rem and not regulated by the Civil Code; this is alien to the regulation techniques applied in the Civil Code. Banks objected to the abolition of independent mortgage and to the fact that the proposal failed to address mortgage securitisation. Contributions made at the seminar and comments sent in writing pointed out that the proposal substantially revised, or else it would lead to major difficulties in applying the charge laws in practice.

## **7. Consultation on the first two books of the new Civil Code**

In May, the Association organised a consultation on the first two books of the proposed new Civil Code: the Introductory Provisions and the Rights of Persons. The completed books of the Civil Code are displayed on the Justice Ministry's website and the professional community may comment on them. At the consultation, Dr Peter Szilas from the Ministry's Civil Law Codification Department gave a presentation on the drafting process of the Civil Code, the introductory provisions, the general rules for legal entities, personal rights and the regulations on associations and foundations. The consultation aroused great interest; more presentations and consultations will be held as the next chapters are completed.

## **8. Dinner for the CEOs of member banks**

Reviving an old tradition, the Association hosted a year-end Christmas dinner for the CEOs of member banks. The event was intended to give the opportunity to top leaders of the 35 member banks attending to meet in an informal atmosphere and exchange views on issues of mutual interest. The President of the Hungarian Financial Supervisory Authority and the Deputy Governor of MNB attended the dinner.

## IV. INTERNATIONAL COOPERATION

### 1. EBF Banking Supervision Committee - Capital Adequacy Working Group

#### 1.1. CRD implementation

The most significant development in EU financial rulemaking in 2006 was that the final version of the CRD, together with its translations, was adopted by the European Parliament and Council in the middle of June and was promulgated in the EU's Official Journal. Member states must adopt the CRD by January 2007. Banks choosing the Standardised Approach or the Foundation IRB Approach may choose between Basel I or the new CRD for 2007. The CRD, including the advanced IRB Approach, will have to be applied from January 2008.

The CRD Transpositions Group was formed in December 2005. The objective of the group is to facilitate correct and coherent transposition of the CRD in members states' legislation and to provide all interested parties with interpretations on the CRD. The EBF set up an electronic forum (clearing house) to address issues arising during the implementation of the CRD. The Basel Committee's Accord Implementation Group is tasked with ensuring consistency in the implementation of the Basel II Accord world wide.

#### 1.2 Review of the Directive on supervisory approval of mergers and acquisitions

The European Commission aims to improve the legal certainty, clarity and transparency of the supervisory approval process with regard to mergers and acquisitions in the banking, insurance and securities sectors. To achieve this, the Commission made a proposal for amending the relevant directives in the above spirit. The objective is to promote market-driven processes, remove unjustifiable obstacles and improve efficiency of the EU internal market. The proposed amendments shorten the deadlines for approval; lay out the prudential criteria for assessing the suitability of the acquirer and set out in details the entire approval procedure.

Following the rapporteur's report in November, the Presidency made a compromise proposal in December. In line with the co-decision requirements, the proposed amendments were scheduled to be decided on by the ECON in January and the EU Parliament in March.

#### 1.3 CEBS<sup>3</sup>

Operations of the CEBS in 2006 were focused on drafting rules for the implementation of the CRD and providing advice at the request of the European Commission (large exposures, own funds).

After wide consultations, the CEBS finalised a number of **guidelines and guidance**, including CP03 on Supervisory Review Process, CP09 on supervisory cooperation, CP10 on the implementation, validation and assessment of the risk management and risk measurement systems, CP11 on additional technical guidance on application of the supervisory review

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<sup>3</sup> Committee of European Banking Supervisors

process (regarding interest rate risk in the banking book and concentration risk), CP02 on standards for the outsourcing of credit institutions' business activities, CP12 on stress tests, and the revised versions of COREP and FINREP. The CEBS also published the results of the survey on the impacts on banks' regulatory capital and total assets of the CEBS prudential filters to be used in the context of the new IFRS.

At the European Commission's call for advice, the CEBS conducted a survey on supervisory practices in the management of **large exposures**. The answers were summarised in reports published by the CEBS in May and in August. In the report on supervisory practices the CEBS focused on the current differences and commonalities in member states' practices (the definition of exposure in the various member states, scope of application, mechanisms for the identification, measurement and monitoring of large exposures, large exposure limits, reporting). Issues addressed in the report on industry practices included approaches to the measurement and management of single name concentration risk, approaches to the measurement and management of other (sectoral, geographic) concentration risk, exposure calculations, the definition and monitoring of connected counterparties, group-level issues, risk mitigation, governance and reporting and regulatory environment. Upon another call for advice from the European Commission, the surveys on Large Exposure will continue in 2007.

At the end of June, the CEBS published a survey on the national implementation of the rules on **own funds** and on market trends. Results of the survey revealed that the rules on own funds are basically similar across Europe. Variations in national rules arise either from the flexibility granted by the CRD, or as a result of local market specificities, differences in national tax and company laws or in prudential approaches. Hybrid instruments were a special focus of the survey (instruments combining the features of both debt and equity). The majority of members apply a 15% limit, as set by the Basel Committee in 1998. The CEBS emphasises that working in parallel with the Basel Committee is crucial to ensure consistency and level playing field at international level. The survey reveals that the European market for hybrids is estimated at around 60 billion euros. The market for hybrid instruments is a fast-growing market in terms of both volume and diversity of instruments. However, market development can also reach its limits if the instruments become too complex and therefore less suitable especially for retail investors.

Upon a Call for Advise from the European Commission within the framework of the Solvency II Project, the CEIOPS<sup>4</sup> made a comparison between the calculation of capital requirements for banks and insurance companies and the eligible elements to cover the capital requirements. The most important difference is in the calculation of solvency ratio on a consolidated basis (at group level) and that insurance companies can take into account the impact of diversification effects at group level in the calculation of capital requirements on the individual entity level.

**Cooperation between the Three Level 3 Committees<sup>5</sup>** has high priority on the CEBS's agenda. Within this framework, a common work programme was issued for 2006. The objectives of the cooperation of the three committees include sharing information, exchanging experience and reducing supervisory burdens.

The **EBF** attaches special importance to its **cooperation with the CEBS**. The EBF is actively involved in the CEBS' consultation processes and has given detailed comments on the various

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<sup>4</sup> Committee of European Insurance and Occupational Pensions Supervisors

<sup>5</sup> CEBS, CESR és CEIOPS: Committees of European banking, securities and pension fund supervisors



documents issued by the CEBS, thus influencing the contents of the final guidelines. The EBF set up working groups to support the drafting of the CEBS's technical guidance on large exposures and own funds.

#### **1.4 U.S. developments - Basel II**

Based on the Fourth Quantitative Impact Study (QIS4), the competent U.S. regulatory agencies already in 2005 announced that the implementation of the Basel II Accord in the U.S. would be delayed compared to the original Basel II schedule. At the beginning of 2006, the U. S. Senate requested the GAO<sup>6</sup> to conduct a study on the impacts of the Basel II capital requirements.

The final NPR<sup>7</sup> was published and submitted to consultation with a substantial delay, in September 2006. The consultation period coincided with that of Basel IA, ending in January 2007. (Basel IA is similar to the Standardized Approach in Basel II, but does not include a capital requirement for operational risk). There will be a separate NPR for trading books. A new provision in the NPR is that, contrary to previous statements, the standardised approach would only be allowed to be used by internationally active large banks, compulsorily subject to Basel II. The Chair of the FDIC<sup>8</sup> made a proposal for applying leverage ratio on a consolidated basis to all banks that are subject to Basle II. The EBF objected to this proposal on several forums, indicating that this would be a step-back from the risk-sensitive approach of Basel II.

A serious problem for banks that are active both in Europe and in the U.S. is that there are a number of major divergences between the CRD and the NPR, whose treatment is unclear (Implementation dates, the definitions of default, the definitions for risk parameters, the LGD estimates, the treatment of intragroup exposures, etc.). Banks would like to avoid investing in duplicative systems. The European Commission seeks systemic solutions to bridge the differences, while the FED favours individual agreements, which may raise level playing field issues.

#### **1.5 BCBS<sup>9</sup> documents**

The Basel Committee on Banking Supervision issued several publications in 2006, aimed at ensuring a uniform interpretation of banking supervision principles and consistent implementation of the new capital accord. The most important documents were as follows:

- Use of vendor products in the Basel II IRB framework
- Core Principles for Effective Banking Supervision (April 2006)
- Core principles methodology (October 2006)
- Results of QIS5
- Home-host information sharing for effective Basel II implementation (June 2006)
- The IRB Use Test: Background and Implementation (September 2006)

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<sup>6</sup> Government Accountability Office - the U.S. national audit office

<sup>7</sup> Notice of Proposed Rulemaking: on the US implementation of the Basel II capital adequacy framework

<sup>8</sup> Federal Deposit Insurance Corporation

<sup>9</sup> Basel Committee on Banking Supervision

- Observed range of practice in key elements of Advanced Measurement Approaches (AMA) (October 2006)
- Studies on credit risk concentration (November 2006)

The BCBS's documents are available on the BCBS's website [www.bis.org](http://www.bis.org).

## **2. EBF Accounts Committee**

The EBF's Accounts Committee held its 62<sup>nd</sup> meeting in Budapest (member states traditionally host meetings of the FBE's technical committees). The Budapest meeting was attended by banking associations and professionals from 18 countries.

At the meeting, the leader of the Fair Value Measurement Working Group presented the Component Approach, developed by specialists for the measurement of fair value based on risk components. This, basically, is a more advanced and extended version of the Fair Value Option. The main feature of this method is that it provides a much more structured and much more specific approach and the target to be achieved through fair value can be identified more clearly. It provides a better and more objective approach to the fair value measurement of less mobile assets and brings IAS 39 closer to the current risk management practices.

Based on the presentation, the Committee concluded that the proposed approach cannot not be regarded as a final, elaborated, method and requires further consultations and fine-tuning.

There was a vigorous debate over the Loan Commissions proposal, developed by Polish specialists. The proposal, undergoing expert review for some months now, draws attention to problems arising from inconsistencies between IAS 18 and IAS 39 in accounting for retail loan commissions and proposes that the US GAAP rules, addressing this issue better, be incorporated into the IAS/IFRS standards. The Belgian Banking Association brought a number of counter-arguments against the written proposal, planned to be sent to the IASB, and did not support sending it. Most committee members shared the Belgian position. It was agreed that, in view of the aspects mentioned, the Polish proposal will first be sent to the European Federation of Accountants (FEE) and if the answer is not satisfactory, the Accounts Committee will revisit the issue.

In relation to the Interest Margin Hedge (IMH) model, not yet adopted by the IASB but long requested by specialists and being continuously complemented and revised to facilitate adoption, it was announced that the working group in charge of developing the proposal is now open to the cash flow hedge approach, proposed by the Accounts Committee as a possible solution and will complete and make available the revised document. It was agreed that the Committee should conduct a survey on how many banks apply in their consolidated financial statements the carved-out version of IAS 39, adopted by the EU. It was also mentioned that the Institute of International Finance (IIF) has developed a proposal to allow easier compliance with the effectiveness requirement in hedge accounting.

## **3. EBF Fiscal Committee**

A major reform is expected in the EU legislation on VAT on financial and insurance services. Directive 77/388/EEC, adopted in 1997, is now ripe for revision. The European Commission launched a consultation aimed at a review and redefinition of VAT-exempt services. The

EBF's specialists are in continuous consultation with the EU Tax and Customs Union Directorate General (DG TAXUD) on the issue and a special working group within the Fiscal Committee is working on the details. A reform of the legislation is especially important for the banking industry, partly to provide for a standard classification of the ever-developing range of financial services within Europe and also to reduce costs of the financial sector (input VAT on supplies is not deductible and cannot be accounted for as cost, given that financial services are VAT-exempt). Due to the VAT burden, international banking groups operating in Europe are disadvantaged compared to other markets. The European banking industry would like to see early solution to the problem.

In Hungary, the Ministry of Finance requested the Association's to cooperate in the issue. In relation to the consultation paper we noted that the provision in the current proposal was more stringent than the general principle, given that for an ancillary transaction to be tax-exempt, the ancillary transaction should be necessary and essential to the transaction exempted. In respect to certain services, references are made to definitions provided in other EU legislation; although this ensures standard definitions within the EU, it cause difficulties for users in applying the VAT Directive. Also, there were many undefined terms in the legislation: we proposed that those be clarified. Further, we proposed to include much more specific service types in the list of services. We also drew attention to certain missing service types and proposed some additions and adjustments to certain provisions of the proposal.

The FBE Fiscal Committee continues to give special attention to practical issues related to the taxation of savings (the Savings Directive). European states eagerly waited for data of the first year to see what size of savings their citizens have placed abroad and what the favourite destinations are. Implementation of the Directive has entailed significant costs in European banking and, based on experience after a year of application, it is apparent that the Directive needs to be reviewed and fine-tuned. Professionals in Europe are of the view that it is in the interest of member states to further develop the legislation and to extend its scope of application geographically (to include Asia) and subject-wise (to include capital gains, dividends and insurance, in addition to interest income).

Preparations for the introduction of a Common Consolidated Corporate Tax Base in Europe commenced. Experts say a five-year period will be required, at least, to clarify all details. Not all member states welcome the idea: the U.K. is expressly against it Germany is in favour. When developing the legislation, the OECD work programme on the attribution of profits to permanent establishments should be also being taken into account. Based on the working papers compiled thus far it is obvious that there is a wide range of issues to be harmonised.

The European Council issued a Code of Conduct on transfer pricing documentation. The objective is to set up a uniform set of rules within the EU, to reduce administrative obstacles and to simplify processes for multinational companies and SMEs. A major aspect in preparing transfer-pricing documentation is that it should provide sufficiently detailed information during a tax audit (structure of the group, characteristics of services, financial and accounting processes within the group), evidence of arm's length pricing between associated companies (explaining the method chosen). Another important aspect is that member states should not impose unreasonable compliance costs and administrative burdens and should not request documentation that has no bearing on transactions reviewed. According to the proposal, a multinational enterprise groups should prepare one uniform set of documentation containing common standardised information relevant for all EU group members and several sets of standardised documentation each containing country-specific information. In view of this Code

of Conduct, it is likely that Ministry Decree 18/2003 on documentation on arm's length pricing will be revised.

#### **4. EBF Payment Systems Committee**

The EBF Payment Systems Committee at its meetings gave special emphasis to the new EU Payments Directive, a prerequisite for the implementation of a Single Euro Payment Area (SEPA). The new Directive is aimed at upgrading the current, basically consumer protection type rules, and providing a legal framework for SEPA, to be established on a self-regulatory basis. The Directive was not completed during the Finnish presidency. Rulemaking was delayed to 2007. The delay may jeopardise the start of SEPA in 2008, given that the transposition of the rules into national legislation will also take time.

Member associations reviewed in detail the European Commission's report on bankcards. This report sharply criticised bank's bankcard financing practices, especially the application of interchange fees. Member states emphasised that interchange fees cover actual costs and their elimination may distort prices and returns. Participants agreed that the FBE should take appropriate measures against the statements made in the report and called on member associations to supply basic information to support this effort.

The European Commission as an important issue that may have a significant impact on banking practices considers account portability. Many members of the committee share the view that the willingness of customers to change banks does not depend on whether or not the account is portable. Trends show that in using banking services customers are not tied to one bank and would choose the bank that offers the best terms and conditions. With standard conditions and rules across Europe, the SEPA payment schemes will further help customers in their choice.

#### **5. EBF Communications Committee**

The EBF Communications Committee held its 30<sup>th</sup> meeting in Berlin. At the meeting, the need for improving the image of the banking community was emphasised. This is aimed to be promoted through increasing corporate social responsibility. The issue of corporate social responsibility involves the pursuit of ethical standards. A document titled *Ethical Performance Best Practice* will be issued as a guide to assist national banking associations in these efforts.

The key issues of Corporate Social Responsibility will be summarised by the EBF in a questionnaire to be sent out to national banking association. Based on the responses, a summary document will be drafted and issued for member associations' use.

The European Banking Federation follows with concern the unacceptable practice of U.S. authorities to solicit data from SWIFT on bank transfers. The banks and customers concerned were not and are not being notified on this practice. The EU and the Belgian government are now investigating the issue. The purpose of the investigation is to find out which organisation is the competent one from data protection points of view.

The Communications Committee announced that the EBF's 2006 Report on Bank Robberies and other Bank Raids was complete and would be published in November. The European

Banking Federation in the future will use the English abbreviation EBF and its logo has been changed accordingly.

## **6. EBF Social Affairs Committee**

The Committee reviewed the impacts of demographic changes on the banking industry. According to a questionnaire survey, although still attractive, banks have started losing their appeal as workplaces; the IT sector has emerged as a main competitor. Banks face increasing difficulties in recruiting qualified staff for certain areas (call centre, back office, etc.). A special problem is the balance between old and new staff.

The recommendations made in the European Commission's Green Book raise a number of issues. National specifics should not be disregarded, the EBF sees it necessary to take further considerations into account; therefore, it will give its position on the Green Book at a later stage.

Flexicurity is a key issue in Europe. The EBF set up a working group to survey the contexts.

The new German Presidency places special emphasis on social affairs and is committed to continuing the work performed thus far. Special attention will be given to job creation, job security, the social minimum and social standards. Currently, there is no legislation on flexicurity; a lot will have to be done in this area in the future.

## **7. EBF Retail Banking Committee**

The Committee reviewed issues related to EU legislation and some new issues arisen. The proposed Consumer Credit Directive is now in its final stage of drafting; however, banks still have problems with a number of issues affecting basic elements of the legislation. The Committee had a vote on the order of priority it should follow in its proposed letter to the EU Presidency on the issues arisen.

Within the legislative process on Mortgage Credit, the European Commission is drafting a White Book; financing issues related to mortgage credits would be reviewed in a specialist committee; consumer protection issues will be discussed with the participation of creditors and consumer protection organisations. Progress in the latter area is particularly slow and there are conflicts regarding the Code of Conduct on pre-contractual information on home loans.

Regarding the *transferability of bank accounts*, most participants agreed that the issue is basically settled at the national level, bank account numbers are transferable in most countries. Participants were of the view that the requirement of account number *portability* (especially between member states) was excessive.

As a new topic, the Committee reviewed the issue of Class Action. Class Action is a legal procedure under which law courts can consolidate lawsuits brought by individual plaintiffs who have similar claims. Class Action is used in consumer protection cases in the United States and some EU member states (Sweden, Germany).

## **8. EBF Physical Security Working Group**

The FBE's Physical Security Working Group analysed the 2005 criminal statistics, based on data provided by the national associations.

The number of crimes and the size of losses both show a positive trend. While the number of raids on bank branches decreased, an alarming phenomenon emerged: raids on cash transporters and ATMs increased. It was anticipated that with the enhancement of branch security, criminals would try to find other ways to get at the money. Although security is often an outsourced activity, disturbances in cash supplies are detrimental to the image of banks.

Branch security is being continuously enhanced through various means. At the same time, taking family members of bank clerks' hostage has emerged as a new and dangerous method. Promising counter-measures were reported by some member states.

At the consultation held on the topic, the increasing internationalisation of crime (especially of bank card frauds) was highlighted. However, statistics also reveal that crimes against banks are typically of a domestic character and their trend does not differ from the general trend of crime in the country in questions.

## V. OTHER ISSUES

### 1. Cooperation with the A Chance for Disadvantaged Children Foundation

The Association concluded a cooperation agreement with the A Chance for Disadvantaged Children Foundation, to support disadvantaged children by using banks' training funds for launching a project titled "*Operation Starting Block - Hungarian Banks for the Education of Young Disadvantaged People*".

Under this project, statutory vocational training contributions paid by banks are used by eligible schools for the education of disadvantaged, primarily Roma, children.

The Foundation has undertaken to search for worthy children, conduct family visits to assess their situation and their families' willingness to cooperate, and to select, by conducting visits, observing classes and assessing educational programs, those schools which are prepared to provide education for disadvantaged children. The sponsor banks with the selected schools will sign contracts.

The project is a joint initiative of the Hungarian banking community and fits in well with banks' social responsibility.

**ANNEX**  
**Board meeting agendas 2006**

Date	Agenda
January 10, 2006	<ol style="list-style-type: none"> <li>1. SEPA and the Hungarian payments system</li> <li>2. Briefing on risks related to foreign currency-based retail loans</li> <li>3. Contribution to the RÉŠ Social and Cultural Foundation</li> <li>4. Financial contribution to the Financial and Capital Market Court of Arbitration</li> <li>5. Miscellaneous</li> </ol>
February 13, 2006	<ol style="list-style-type: none"> <li>1. Proposal for main tasks for the Hungarian Banking Association in 2006</li> <li>2. Review of the 2006 financial management of the Hungarian Banking Association based on January-September facts and Q4 forecast.</li> <li>3. Proposal for the 2006 budget of the Hungarian Banking Association</li> <li>4. Proposal for legislation to extend the data supply operations of GIRinfo</li> <li>5. Proposal for amendment to the Operational and Organisational Rules of the Payment System Forum</li> <li>6. Miscellaneous</li> </ol>
March 6, 2006	<ol style="list-style-type: none"> <li>1. Briefing on medium-term tasks for GIRO Ltd. Presenter: Péter Legeza, CEO, GIRO Ltd.</li> <li>2. Briefing on preparations for setting up the Hungarian SEPA organisation Presenter: Péter Legeza, CEO, GIRO Ltd.</li> <li>3. Report on 2005 activities of the Hungarian Banking Association (Document for the General Meeting)</li> <li>4. Proposal for main tasks for the Hungarian Banking Association in 2006 (Document for the General Meeting)</li> <li>5. Report on the financial management of the Hungarian Banking Association in 2005 (Document for the General Meeting)</li> <li>6. Proposal for the 2006 budget of the Hungarian Banking Association (Document for the General Meeting)</li> <li>7. Proposal for revising the Association's membership fee rules in respect of bank group members</li> <li>8. Miscellaneous</li> </ol>
April 10, 2006	<ol style="list-style-type: none"> <li>1. Expected impacts of the Hungarian Financial Supervisory Authority's proposed new supervisory fee system</li> <li>2. European Payments Council (EPC) elections, Hungarian representation</li> <li>3. Miscellaneous</li> </ol>
May 8, 2006	<ol style="list-style-type: none"> <li>1. Proposals of the Hungarian Banking Association for reducing the State budget deficit and on structural reforms affecting general government</li> <li>2. Communications plan of the Hungarian Banking Association for 2006</li> <li>3. Request from the Association of Hungarian Mortgage Banks</li> <li>4. Financial management of the Hungarian Banking Association in Q1 2006.</li> <li>5. Proposal for setting up the Accounting and Finance Committee</li> <li>6. Miscellaneous</li> </ol>



June 6, 2006	<ol style="list-style-type: none"> <li>1. Strategic plan of the Hungarian Banking Association</li> <li>2. Briefing on projected special bank tax payments in 2006.</li> <li>3. Proposal for revising the Association's membership fee rules in respect of bank group members</li> <li>4. Miscellaneous</li> </ol>
September 4, 2006	<ol style="list-style-type: none"> <li>1. Strategic plan of the Hungarian Banking Association</li> <li>2. Briefing on measures related to the introduction of interest tax</li> <li>3. Briefing on the financial management of the Hungarian Banking Association in the first half of 2006</li> <li>4. Briefing on negotiations on the Association's office rental contract</li> <li>5. Briefing on the setting up of the Accounting and Finance Committee</li> <li>6. Briefing on the extension of the cooperation agreement with PricewaterhouseCoopers</li> <li>7. Miscellaneous</li> </ol>
October 9, 2006	<ol style="list-style-type: none"> <li>1. Issues to be raised at the Association's meeting with the Supervisory Council</li> <li>2. Background document for the press meeting (Main economic and financial developments in 2006)</li> <li>3. Submission on customer protection issues related to the proposals of the Hungarian Financial Supervisory Authority</li> <li>4. Briefing on the setting up of an Operational Risk Database in Hungary</li> <li>5. Briefing on projected special bank tax payments in 2006</li> <li>6. Briefing on a request from The Wall Street Journal</li> <li>7. Briefing regarding the Association's office rental contract</li> <li>8. Miscellaneous</li> </ol>
November 6, 2006	<ol style="list-style-type: none"> <li>1. Proposal by the Accounting and Finance Committee</li> <li>2. Briefing on the calculation of APR for promotional home loans</li> <li>3. Submission on the impact on the Association's budget of the change in the EPC membership fee</li> <li>4. Proposal for the admission of Allianz Bank to the Hungarian Banking Association</li> <li>5. Miscellaneous</li> </ol>
December 6, 2006	<ol style="list-style-type: none"> <li>1. Report on 3<sup>rd</sup> quarter activities of the Hungarian Banking Association</li> <li>2. EPC membership fee 2007</li> <li>3. Report on the financial management of the Hungarian Banking Association Q1 - Q3, 2006.</li> <li>4. Report on the Association's portfolio management</li> <li>5. Briefing on projected special bank tax payments in 2006</li> <li>6. Miscellaneous</li> </ol>