HUNGARIAN BANKING ASSOCIATON

REPORT

ON 2007 ACTIVITIES OF THE HUNGARIAN BANKING ASSOCIATON

BUDAPEST, MARCH 2008

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I. THE ECONOMY AND THE BANKING SECTOR IN 2007

1. INTRODUCTION

Global economic growth slowed by 0.4%, the pace of growth of the Hungarian economy slowed by 2.5% in 2007. A major development during the year was the drying up of ample liquidity seen in previous years. Industrial production and exports grew significantly; consumption, real wages and the deficit of general government decreased, employment and investment remained at the previous year's level. The depth of financial intermediation continues to be low compared to the level of economic development. Retail lending grew at two-thirds of the 40% average growth rate of the previous years; corporate lending continued to rise at an annual rate of 12%. According to preliminary data, with net interest margin dropping by 3.3%, banks' average nominal ROE decreased by 16%, real ROE by 8%.

2007 saw significant changes in global economy, in Hungary's economy and in the banking industry:

- A decade of ample liquidity in the ***global economy*** ended. The reasons are still to be analysed, but the phenomenon was marked. Economic developments at the end of 2007 were characterised by slowing economic growth, inflation rising again and borrowing becoming more expensive and scarce in sources. Very little is known about how long these tensions in the global economy may last (whether a year, or longer), their extent (a slowdown without recession, or the slackening of production), their geographic scale (the U.S., EU, China or the entire world) and their sectoral implications (whether it is the financial sector to be predominantly affected or this is just an initial entry to the costs of the real economy: there are diverging views in assessing the situation.

- By the end of 2005, significant tensions had developed in the ***Hungarian economy.*** The Association had been continuously drawing the government's attention, **urging and proposing measures to correct economic policy tensions:**
  - At the end of 2005, the **Association analysed the situation** of the Hungarian economy **and concluded that there was no imminent threat of a financial crisis, but if the causes of economic distortions are not eliminated, the situation would become unmanageable**: "**The Hungarian banking community's opinion is that *economic development in Hungary is satisfactory and there is no near-crisis situation.* However, there are some serious *disequilibrium problems* hindering further growth. It is in Hungary's fundamental interest to transform those systems of general government which currently provide poor and costly services, thereby causing a persistently high budget deficit and imposing high tax burdens on the economy and, thus, reducing its competitiveness**."
  - **In the summer of 2006** (following general elections) the **Association gave an evaluation** of the government's plans aimed at improving equilibrium: "We approve of the primary objective of the *New Equilibrium Programme,* i.e. that **the financial imbalance** evolving in the period 2001 and 2006 **should be mitigated through short-term measures as well**. **The *New Equilibrium* programme marks the start of settling the problems accumulated over years**. For a long time it was clear that the reestablishment of the equilibrium would be inevitable in the weeks-months following the parliamentary elections

at the latest. Yet **the plans announced now contain exclusively short-term measures whose structure is open to doubt**. **The technical grounding of some of the measures is inadequate,** and the extent of the budgetary adjustment that would result from the envisaged measures overall can also not be assessed. **The most important constituent of a lasting financial stabilisation - structural reforms - is lacking for the time being**."

- **Corrective measures were finally launched in 2007**. These have not only improved equilibrium in the short-term (by reducing the budget and current account deficits) but are also a preparatory step in a comprehensive reform of the subsystems of general government (legislation was enacted on the introduction of a multi-fund health care system, some railway services were privatised and tuition was introduced in higher education to make it partly self-financing).
- **2007 was also a turnaround for the *banking industry*. Declining real incomes and consumption and slackening investments led to a drop in demand for loans**. Net interest margin dropped significantly, partly due to borrowers' preference of low rate foreign currency loans to higher rate HUF loans and, more importantly, due to a substantial increase in international interbank borrowing costs, which could not be fully transferred to customers. Specific operating expenses did not decrease in 2007, inter alia due to network expansions.

In summary: while Hungarian banks' rates of return significantly exceeded the international average between 2001 and 2006, their rates of return, and especially real rates of return, converged to the EU average in 2007. (Here, it should be noted that banks, making negative real profits between 1994 and 2000 following consolidation and privatisation were able to fully regain the lost profits over the next six years).

2. MACROECONOMIC DEVELOPMENTS

1. The global economy in 2007

Global economic growth slowed down somewhat, from 5.3% to 4.9% in 2007. This was primarily due to a 1.4% slowdown of economic growth in the U.S. and other developed economies stagnating. Economic growth dropped by one-tenth of a percentage point to 2.7 in the Euro-zone, and by 0.2 percentage points to 2.0% in Japan, while rising by 0.2 percentage points to 3.0% in the U.K. In the developing world, the economies of China and India continued to grow extremely rapidly (China's economic growth rate rose by 0.6 percentage points to 11.3 percentage points).

According to a Capital Economics forecast (2007/3), except for Japan, the growth pace of all major economies will remain below the 2006 level in 2008. The pace of economic growth between 2006 and 2008 is expected to drop by approx. 1.7% in the U.S., 0.7% in Canada, 0.5% in the Euro-zone and 0.1% in China, Japan's economic growth is expected to accelerate by 0.2%. According to Capital Economics, a slowing GDP growth will be accompanied by slowing inflation. Global inflation between 2006 and 2008 is expected to fall by 0.5 percentage point, from 3.8% to 3.3%. Oil prices soared at the end of 2007, 2008 price outlooks are uncertain. Gold prices grew at an even pace between 2002 and 2008, from USD 349 an ounce in 2002 to USD 800 in 2008. The US Dollar continued to weaken against the Euro.

A major global economic development was the ***drying up of ample liquidity*** in the global economy by 2008. The U.S. sub-prime mortgage market crisis unveiled the serious problem of financial institutions and supervisory authorities failing to pay adequate attention to liquidity risks and their management. In this context, the banking industry is faced with a general issue: inadequate risk management and ineffective supervision may also occur in areas other than home lending: ample liquidity in recent years pushed lending based on proper credit rating in the background. As a direct consequence of drying up liquidity, interventions by central banks and by the EU and the ECB were required in a number of industrialised countries.

2. The Hungarian economy

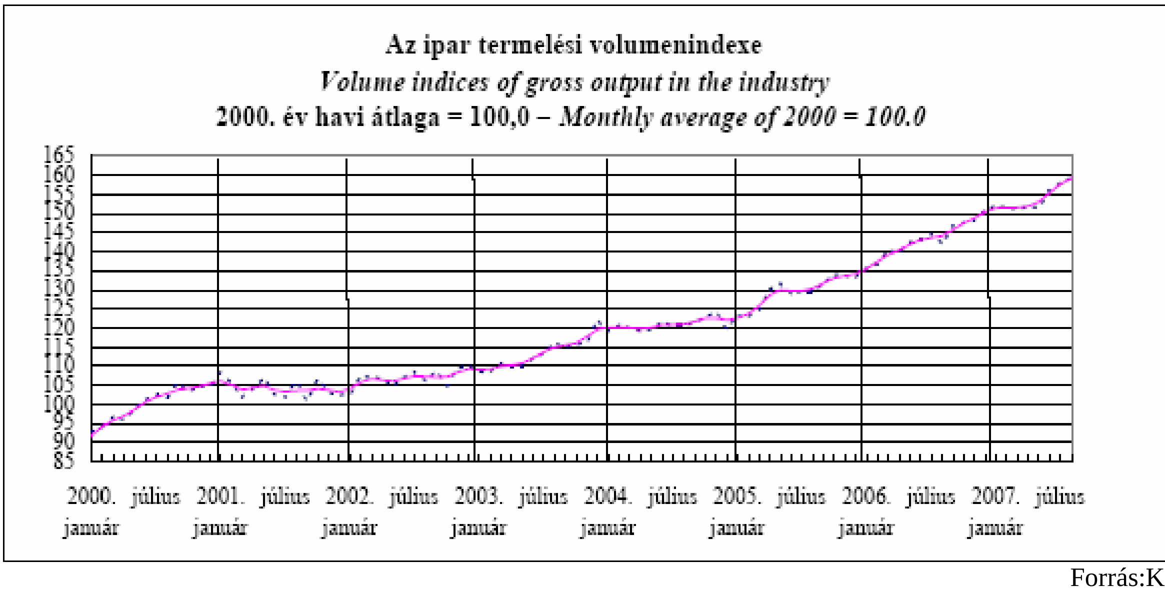
Hungary's ***GDP grew*** at an annual average of 4% in the period between 2001 and 2006. This growth pace dropped to 1.3% in 2007. According to Government estimates, GDP is expected to grow again at an annual of pace of 4% to 5% between 2009 and 2011. According to analysts, the realistic figure is at least 1% slower than this estimate. The nature of growth in 2007 is difficult to grasp: industrial production grew by 9% in the first eight months of the year (relative to a high 2006 base), exports grew fast, the balance of trade is expected around a zero balance in 2007, manufacturing investments were high. Due to measures affecting the administrative, health care and education systems, the volume of public services decreased. This, together with the decline in consumption, played a major role in the slowdown of economic growth.

GDP (previous year =100%)

%

	2001	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**
GDP	104,1	104,4	104,2	104,8	104,1	103,9	101,3

Industrial production grew by 7% in 2005, 9.9% in 2006 and 8.1% in 2007. The output of manufacturing exceeded the monthly average of 2000 by 34.2% in 2005, 49.8% in 2006 and 68% in October 2007 (seasonal and working day adjusted).



Forrás:KSH

Investments rose at a growing pace each year between 1996 and 2005. This trend stopped, with investments dropping by 2% in 2006 and expected to show a further decline in 2007. Investments in manufacturing continued to grow significantly in 2007, while remaining at the previous year's level or declining in other sectors of the economy. Public sector investments in each quarter were 20% to 30% lower than in the same quarters in the previous year.

Exports grew rapidly, the volume of imports now barely exceeds that of exports. Ten years ago only 90% of imports was covered by exports. This ratio had reached 100% by the end of 2007, due to the rapid and steady increase in exports (at an annual rate of 17%).

The Government's annual average ***inflation rate*** forecast was 3.5% for 2006, 6.2% for 2007 and 3.3% for 2008. The actual inflation rate in 2006 was 3.9%. However, in December 2007, consumer prices were already 8% higher than in the previous year, thus "overdoing" the expected inflation rate by 1.5 to 2.0 percentage points.

Consumer price indices

%

1995	**128.2**
1996	**123.6**
1997	**118.3**
1998	**114.3**
1999	**110.0**
2000	**109.8**
2001	**109.2**
2002	**105.3**
2003	**104.7**
2004	**106.8**
2005	**103.6**
2006	**103.9**
2007	**108.0**

Source: MNB

Inflation declined significantly over the last ten years; analysts expect that the speed up of 2007 may be absorbed in a couple of years and will be back in the range below 4% from 2009. At the same time, the onset of a serious external shock, boosting inflation, cannot be ruled out (for example, the impact of the sub-prime crisis on the real economy, oil prices, etc.). Although controlled prices showed a double-digit increase each month over the same period in the previous year, given their low importance, they did not have a major bearing on inflation. Among market commodities, free-market household energy prices showed a double-digit hike between January and August, the effect of the 20% price increase of September 2006 only subsiding in September 2007 with a bare 2% increase in that month. A 10% increase in food prices, mainly due to the drought in 2007, also contributed to the high CPI. Industrial product prices rose the least, prices in the services sector rose above inflation.

A higher inflation rate also contributed to *household consumption* barely decreasing by 0.8% in the first quarter, 3.4% in the second quarter and 0.2% in the third quarter of 2007 as opposed to the 0.9% in decrease forecast for the year. End consumption declined by 2.9% in the third quarter, with household consumption dropping by 2.4%. Gross wages in the national economy rose by 8.0%, with a 9.1% increase in the competitive sphere and 6.4% in the public sphere.

Ever since transition, the Hungarian economy has been characterised by a low ***employment rate***. The number of those employed rose by an annual 10,000 to 11,000 people from 2001, to decrease by 3,900 to 3,926,200 in 2007.

Number of persons employed

2001	3 868 300
2002	3 870 600
2003	3 921 900
2004	3 900 400
2005	3 901 000
2006	3 930 100
2007	3 926 200

Source: Hungarian Central Statistical Office

The rate of employment in Hungary in 2003 was 57% as opposed to 63% in the EU25. This means that it would take 400,000 more persons employed to reach the EU25 rate. This increase is in itself low. With the current pace of increase, it would take close to 40 years for Hungary to reach the rate of employment in the EU25 states. The Lisbon target of a 70% employment rate means an additional 500,000 people to be employed; in other words, more than 1 million people less are employed in Hungary than the EU objective. In 2006, the rate of employment in Hungary was 57.3% versus 72% in the U.S, 66.1% in the OECD countries, 64.7% in the EU19 states.

The rate of employment among those aged between 15 and 64 grew from 63.2% in 2000 to 66.9% in the EU15 states. The rate of growth in Hungary in this age category was more modest (from 55.7% to 57.6%), with the gap widening from 7.5 percentage points to 9.3 percentage points, placing Hungary last among the EU27 states (excluding Malta). Within Hungary, there are great differences in employment rates by region: the rates of employment in Western, Central Transdanubia and Central Hungary were 63.4%, 61.8% and 62,7% respectively, in Northern Hungary, the Northern Plain and Southern Transdanubia 50.5%, 50,8% and 51,2%, respectively and 55.2% in the Southern Plain. In short: the most advanced regions in Hungary are barely at the EU15 employment rate seven years ago. Borsod, Szabolcs and Somogy counties have an employment rate below 50%. The rate of employment of women with the same qualification is 10% to 15% lower. By qualification, the (rounded) employment rate among those with a degree is 80%, those with secondary vocational or training school diploma 70% and those with a general secondary, primary school diploma or unfinished primary school 45%, 27% and 8%, respectively.

The ***HUF/EUR*** exchange rate between 2000 és 2007 fluctuated around HUF 253 with a relatively small deviation (with some bigger fluctuations for shorter periods from time to time). During this period, the forint significantly appreciated by all effective real exchange rate indices against the euro (by 30% based on difference in consumer inflation rates). The relatively steady nominal exchange rate and strong real appreciation of the forint has not set back exports thus far and has contributed to the slowing down of inflation.

Fiscal policy has been the main point of stress in macroeconomy in recent years. Fiscal policy added to a great extent to the excessive rise in wages and consumption, with the budget deficit rising to 10% of GDP and the general government debt increasing. Household savings plummeted - inter alia, due to cheap home loans and consumer credits - down to close to zero.

2007 was a year of ***budgetary adjustment***. In one year - although with significant growth sacrifices - about 4 percentage points reduced the deficit of general government. After six years, the ratio of government debt to GDP ceased to rise and stopped at 65.6%.

The key questions are how successful the first steps in streamlining a wasteful state structure will be; whether the former wasteful structure will not fat back once austerity measures are relaxed; whether the tax system will be transformed into a competition-friendly system; whether tax evaders can be turned into taxpayers; whether the planned transformation of the health care system will attract the interest of business insurers; whether a demand-driven vocational training system can be established in education; whether economies of scale can be achieved in the currently wasteful local government system; whether Hungarian Railways (MÁV) can be made competitive or the decade long wrangling of reduce the number of lines or not-reduce, privatise or not privatise, will continue. Unfortunately, no positive answers can yet be given to these questions at the beginning of 2008.

3. PERFORMANCE OF THE BANKING SECTOR IN 2007

1. Hungarian banking in international comparison

The ***depth of financial intermediation*** in Hungary continued to grow in 2007; however, it is still modest by international comparison. The depth of financial intermediation is measured by the private loans to GDP ratio and its adequacy to the level of development (GDP per capita) of the country. The depth of financial intermediation in Hungary shows a gradual convergence to the international trend.

Year	GDP/capita USD	Hungary Costumer loans/GDP ratio %	Private loans/GDP ratio trend %	Difference between the Hungarian ratio and the trend %
2001	8.48	25.78	51.69	25.91
2002	9.54	25.59	52.33	26.74
2003	10.52	31.29	54.62	23.34
2004	11.50	34.14	56.93	22.80
2005	12.25	38.33	58.67	20.35
2006	13.19	41.92	60.88	18.96
1st quarter 2007	13.45	43.15	61.47	18.32

Source: estimates based on figures of the Hungarian Financial Supervisory Authority

Figures reveal that the depth of financial intermediation in Hungary is gradually increasing, catching up by approximately 1% each year, but still significantly lagging behind the international trend.

2. Main characteristics of the industry in 2007

In analysing banking in 2007 we will use preliminary figures of the Hungarian Financial Supervisory Authority, these may somewhat differ from the audited figures.

	2001 Audited	2002 Audited	2003 Audited	2004 Audited	2005 Audited	2006 Audited	2007 Preliminary
GDP (HUF billion)	15 270.1	17 180.6	18 940.7	20 717.1	22 055.1	23 757.2	25 700
Customer loans/ GDP (%)	25.8	25.6	31.3	34.1	38.3	41.9	45.8
Assets /GDP (%)	59.2	59.3	67.9	72.0	79.6	87.4	94.8

(customers=households+corporate)

Source: estimates based on figures of the Hungarian Financial Supervisory Authority and the Hungarian Central Statistical Office

Corporate loans grew both in 2007 and on a six year average at a rate of 12%. The pace of growth of retail loans slowed significantly, with a 26% increase in 2007 against the seven-year average of 40%. ***Central bank and interbank deposits dropped significantly in 2007, to 68% of the 2006 level, indicating a diminishing liquidity in the Hungarian market, too***.

The stock of corporate loans doubled between 2001 and 2007 that of retail loans rose seven and a half times. If corporate and retail loans continue to grow at the pace they did over the past few years, the stock of retail loans may exceed that of corporate loans in 2008. A further rapid increase in lending may be significantly slowed by scarce liquidity. A growing dependence on liquidity (interbank and parent bank resources) is indicates by ***the loans to deposits ratio rising from 80% six years ago to over 150% by 2007.***

Annual growth rate (%)

	2002/ 2001	2003/ 2002	2004/ 2003	2005/ 2004	2006/ 2005	2007v/ 2006
Securities for trading	-6.0	47.2	-4.3	-2.6	48.0	77.3
Securities for investment	5.5	39.8	-1.8	7.3	-0.4	12.0
Central bank deposits	30.5	-34.0	27.6	138.6	-6.6	-63.0
Interbank deposits	-18.5	7.6	24.3	-17.2	32.1	0.4
Corporate loans	-0.5	22.9	14.1	13.7	11.4	12.3
Retail loans	67.8	67.2	29.9	29.7	27.8	26.3
Total assets	12.8	26.1	15.9	17.8	18.2	17.3

Source: estimates based on figures of the Hungarian Financial Supervisory Authority

The share of ***foreign currency assets*** in total assets, being between 30% and 34% between 2000 and 2002, had risen to 49.5% by the end of 2007. The share of foreign currency loans in total retail loans, taking up a bare 3% in 2001 had grown steadily to 59.5% by the end of 2007. The share of foreign currency loans in corporate loans was 53.7%. The stock of forint corporate loans has not increased since November 2007 that of forint retail loans is at the 2004 level. Securities for trading were the only forint-denominated assets showing growth, 1.8 times the 2006 value.

Share of foreign currency loans (%)

	2001	2002	2003	2004	2005	2006	2007.
Total loans	36.9	36.2	39.8	42.9	50.2	54.1	63.3
Non-financial corporate	34.3	35.0	40.7	44.5	47.6	47.3	53.7
Households	3.1	3.0	5.0	14.6	32.6	46.8	59.5

Source: Hungarian Financial Supervisory Authority

a.) In **retail lending,** the share of ***consumer loans***, taking up slightly less than a quarter of all retail loans in 2001, dropped to below one-fifth in 2003, to then rise again to over one-third by the end of 2007. Consumer loans increased by 40.5%, a considerably rapid pace, albeit slightly slower than the 47% of 2006. ***Home loans,*** making up more than half of all retail loans, grew by 17.1% in 2007, the lowest growth in six years. Home loans**,** taking up a bare one-third in total retail loans in 2001, rose as a result of subsidised lending to over two-thirds in 2003, to decrease to 54.7% in 2007. The share of sole proprietors fell from a low 6% to below 2%.

Growth rate (%)

		2002/ 2001	2003/ 2002	2004/ 2003	2005/ 2004	2006/ 2005	2007/ 2006
Total retail loans (1.+ 2.)		71.5	66.1	29.8	29.8	27.9	26.4
1.	Retail loans	75.7	67.8	30.1	30.4	28.4	26.7
1.a	Overdraft	56.9	35.9	39.5	54.0	45.5	44.9
1.b	Consumer loans	36.5	77.8	33.1	79.0	47.0	40.5
1.c	Purpose credit	-41.7	85.7	-7.7	466.7	-65.6	-1.8
1.d	Home loans	166.4	99.8	27.4	20.5	19.0	17.1
1.e	Other loans (including real pension transactions)	-5.3	-50.8	51.3	-41.8	37.2	46.6
2.	Sole proprietors	5.9	23.0	20.5	6.1	5.8	12.3

Source: estimates based on figures of the Hungarian Financial Supervisory Authority

Share in total retail loans (%)

	2001	2003	2007
Overdraft	4.0	3.0	5.0
Consumer loans	23.2	19.8	35.7
Purpose credit	0.2	0.1	0.0
Home loans	37.3	69.6	54.7
Other loans (including real pension transactions)	29.3	4.8	3.1
Sole proprietors	6.0	2.8	1.5

Source: estimates based on figures of the Hungarian Financial Supervisory Authority

b.) In **corporate lending,** the share of ***SME loans*** grew steadily. Within SME loans, the share of loans to micro and small enterprises increased slightly.

HUF billion

	2001	2007
SME loans	1 280.7	**3 649.3**
Loans to large corporate	1 953.1	3 649.3
Total corporate loans	3 233.8	6 419.4
Share of SME loans (%)	39.60%	56.9 %

Source: Hungarian Financial Supervisory Authority

Share in SME loans (%)

	2001	2004	2007
Micro	32.5	33.6	35.1
Small	23.5	20.5	29.3
Medium-sized	44.0	45.9	36.6
Total SMEs	100.0	100.0	100.0

Source: Hungarian Financial Supervisory Authority

c.) The ***quality of assets*** continues to be good. The ratio of problematic debts (substandard, doubtful and bad) is low.

d.) Loans grew more than twice as fast as deposits over the past six years. The difference was even more striking in ***2007***: ***loans grew by 22.1%, deposits by 6.9%. The loans to deposits ratio grew from 80% in 2001 to 153% in 2007.*** In **liabilities,** ***debt securities*** grew the most rapidly over the past six years, by an average 60% each year and by 20.3% in 2007. ***Interbank deposits and loans taken*** rose at an annual average rate of 29% and 27%, respectively, over the past six years and by **49.6 and 30.1**% in 2007. Own funds made up about 9% of total liabilities each year.

Main liabilities of the banking sector between 2001 and 2007

(%)

	2002/2001	2003/2002	2004/2003	2005/2004	2006/2005	2007/2006
Deposits	10.0	9.3	8.5	12.6	13.0	6.9
of which: corporate deposits	19.3	12.0	4.7	12.0	23.8	1.5
retail deposits	6.8	14.1	10.6	9.1	4.2	6.3
Interbank deposits	-3.4	70.8	17.4	45.0	27.1	49.6
Loans taken	14.2	74.4	29.0	19.3	13.2	30.1
Debt securities	190.1	139.2	35.1	19.1	15.0	20.3
Interest accruals	24.8	98.0	57.1	-12.7	8.2	37.7
Other accrued settlements	6.0	-6.1	47.7	25.8	50.4	-3.3
Subordinated liabilities	4.0	34.2	3.4	49.1	100.1	10.3
Provisions	20.1	27.7	-5.2	6.0	30.2	6.5
Own funds	15.8	20.7	17.9	13.6	19.7	18.3
Total liabilities	12.8	26.1	15.9	17.8	18.2	17.3

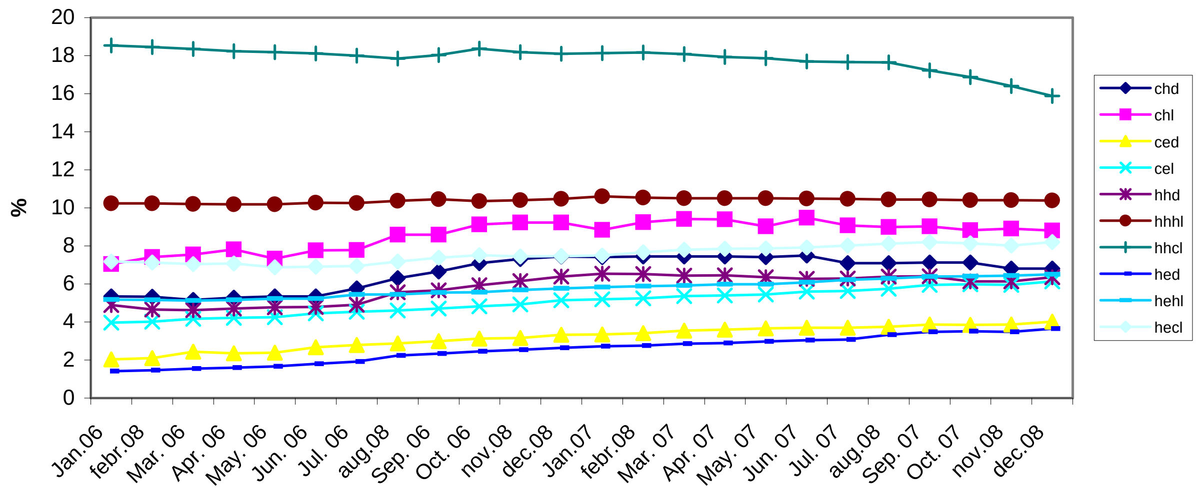
Source: estimates based on figures of the Hungarian Financial Supervisory Authority

The share of ***foreign funds*** has increased significantly over the past years, from 16% in 2001 to 25.7% in 2007.

3. Profitability

a.) The deviation of ***interest rates*** decreased significantly in 2007 compared to 2006. Low interest rates on euro-loans rose; high interest rates on consumer loans fell. On aggregate, nominal interest rates rose by an average 1.2%.

Convergence of Retail and Corporate Deposit and Loan Interest Rates
January 2006-December 2007



Source: MNB

b.) With a slowing activity, banks' ***profits*** grew slower in 2007. Also due to a slowdown in activity, the ratio of operating costs to total assets - after a long time - stopped decreasing in 2007 and remained at 2.7%. Net interest margin declined, as it did in the previous four years (2002: 4.0%, 2003: 3.9%, 2004:4.0%, 2005: 3.9%, 2006: 3.6%, 2007: 3.2%), although never so sharply. The 2007 decline can be attributed to the fact that while interest expenses grew by 0.9%, interest revenues, lagging behind, barely rose by 0.5%. Non-interest income grew by at 1.2%, a somewhat higher rate than 2002-2006 average.

HUF billion

	2001 Audited	**2002 Audited**	**2003 Audited**	**2004 Audited**	**2005 Audited**	**2006 Audited**	**2007 Preliminary**
Interest received	784.6	846.4	1 049.7	1 438.9	1 387.9	1 514.9	1 842.7
Interest paid	443.9	459.8	597.1	889.3	765.1	817.1	1 123.9
Net interest income	**340.7**	**386.6**	**452.6**	**549.6**	**622.8**	**697.8**	**709.9**
Non-interest earnings	**86.2**	**107.8**	**145.5**	**190.1**	**225.8**	**223.9**	**259.0**
of which: earnings from commission and fees	98.6	128.8	168.8	181.0	207.2	229.9	246.6
dividends	4.9	8.3	21.7	19.1	22.2	28.1	36.2
gains on forex trading and exchange rates	43.4	49.4	54.8	89.0	45.9	46.6	54.7
other non-interest earnings	-186.6	-78.6	-99.8	-99.0	-49.4	-80.7	-78.5
of which: net loss in value and provisions	*n.a.*	*-59.9*	*-83.7*	*-81.3*	*-77.5*	*-150.1*	*-134.0*
Operating expenses	**301.0**	**341.9**	**389.7**	**417.9**	**469.0**	**525.5**	**586.1**
Extraordinary income	**7.2**	**3.0**	**3.7**	**0.2**	**1.3**	**29.7**	**-2.6**
Profit before tax	133.1	155.5	*212.2*	*322.0*	*380.9*	*425.9*	*380.1*
Profit after tax	***107.4***	***127.9***	***174.4***	***275.1***	***314.2***	***356.8***	***329.4***
Own funds, average (estimate)		827.2	979.4	1199.1	1409.6	1648.9	1942.9
Total assets average (estimate)		9617.9	11528.1	13788.5	16034.7	19367.5	22080.8

If the audited figures for 2007 will be in line the preliminary results, then ROE in was 17.6% in 2007 and real ROE (ROE adjusted by the consumer price index) 8.9%, basically coinciding with the common real ROE rate in the EU. A 5.4 percentage-point fall in nominal ROE in 2007 is attributable to the fact that the volume of interest paid rose 0.4% faster than the interest received, which at a gearing ratio of 11 or 12 times, warrants a 4.5 percentage-point deterioration. All this is due to the diminishing of liquidity and declining demand for loans.

%

	2002 Audited	**2003 Audited**	**2004 Audited**	**2005 Audited**	**2006 Audited**	**2007 Preliminary**
ROE	15.5	17.1	23.4	22.3	23.0	**17.6**
ROA	1.1	1.5	1.9	1.9	1.8	1.5
Cost-to-income	**59.0**	**58.0**	**50.9**	**49.2**	**50.1**	**61**

IN SUMMARY:

- The Hungarian economy set off on the path of macroeconomic stabilisation in the second half of 2006. The process of returning to a sustainable growth path is painful (GDP growth slowed, real wages declined, consumption dropped) but successful (the budget deficit was reduced and the balance of trade closed at a close to zero balance). The implementation of reforms needed for a sustainable growth has not been smooth; in many cases the details of the models to be implemented are unclear.

- Increasing the rate of employment is crucial and important also for increasing the depth of financial intermediation. Without this, a further substantial increase in SME lending does not seem possible. Retail lending continued to grow relatively rapidly in 2007, but the pace of growth has been slowing for years. The volume of retail forint loans has declined, that of foreign currency loans has continued to grow. The interest rates of retail loans in forints have fallen, those of loans in euro, (half those in forint), have moved cyclically; however, given that the share of euro loans has increased, weighted average retail interest rates have declined.

- The ratio of net interest margin to total assets has been declining for years now, and especially sharply so in 2007. In 2008, the economy is expected to pick up slightly, so, the 2007 GDP growth figure was hopefully the low point. The corporate lending market is also expected to pick up; EU development funds may indirectly stimulate SME borrowings. Retail lending is expected to grow at the same pace as in 2007. Net interest margin is expected to further narrow by 0.1%, although this will be somewhat offset by decreasing operating expenses.

II. PROFESSIONAL ISSUES

1. Transposition of EU financial legislation

1.1. CRD transposition

Extensive consultations were conducted in the process of transposition of the Capital Requirements Directive (Directives 2006/48/EC and 2006/49/EC) into Hungarian legislation in 2007. As a first step in the implementation process, the Hungarian Parliament passed the amendment to the Credit Institutions Act (Act LI of 2006) - with a six-month delay - in June. The Act came into force on July 1, 2007. The Hungarian Government adopted the Decrees on the treatment of and capital requirements for credit risk (Government Decree No. 196/2007 [VII 30]), the treatment of and capital requirements for operational risk (Government Decree 200/2007 [VII 30] and on disclosure requirements for credit institutions (Government Decree No. 234/2007 [IX 4]). In early autumn, the Ministry of Finance Decree No. 21/2007 (IX.15.) on investment rules for credit institutions, effective from January 1, 2008, was issued. As a final move in CRD implementation, the Government Decrees on trading books (Government Decree No. 345/2007 [XII.19]), securitised positions (Government Decree No. 380/2007 [XII.23]) and counterparty risk (Government Decree No. 381/2007. [XII.23]) were adopted in December 2007. These Decrees are the transposition of the Annexes to Directive 2006/48 and the provisions of Directive 2006/49. With this, Hungary - **with a year delay** - met its law harmonisation obligations, although the transposition of the CRD was still not full in scope.

The Hungarian Financial Supervisory Authority published the tables of the proposed CRD reporting framework (COREP[1]) in December. The final version of the Supervisory Authority's reporting requirements was published on the Authority's website on February 12. (According to our information the proposal was passed in an unchanged form by the rulemakers, the Ministry of Finance). **Upon the Association's request,** in view of the delay in rulemaking, the **deadline for first quarter reporting** (on capital as of March 31, 2008) **has been set as May 2008.**

The Association provided a number of comments and proposals to the texts of the proposed decrees(as did the Hungarian Financial Supervisory Authority and the MNB), aimed at ensuring accurate and proper transposition of the CRD. Some of our proposals were rejected and the decrees issued contain a number of inaccuracies and misinterpretations. The Ministry of Finance promised that the legislation will be reviewed based on experiences gathered during implementation, and corrected, where appropriate. The Association had to turn to the Minister of Finance several times to achieve that the Ministry's staff take into account our comments and avail itself of the Association's assistance.

As part of CRD implementation, the Association's lawyers reviewed the application of credit risk mitigation provisions of the CRD in the Hungarian regulatory environment. The Association sent the Ministry of Justice and the Ministry of Finance a summary of the initial discussions and comments received, drawing attention to problems related to the regulations on collaterals. Certain provisions in the Bankruptcy Act and the Act on Judicial Distraint weaken the enforceability of collaterals. We expressed similar concerns regarding the collaterals framework in the proposed new Civil Code.

[1] Common Reporting Framework

A major step in CRD implementation in Hungary was the launch of the live upload of the **Hungarian Operational Risk Database (HunOR)**, set up by 13 banks. Participants in the database are reporting operational risk losses over HUF 50,000 on a quarterly basis. The IT system for the database was implemented by WIT-SYS Consulting. The system is operated by GIRO Ltd., the project was managed and its professional oversight continues to be performed by the International Training Centre for Bankers. Parallel with the setting up of the database, a data collection guide was compiled to promote the development and implementation of common operational risk standards. In the process of setting up the database the participants also consulted with the Hungarian Financial Supervisory Authority, given that the ultimate objective of this common project is to enable banks to use the database in a manner meeting the Supervisory Authority's requirements, as an external loss data source. The HunOR database and the related technical framework were financed from participants' contributions and a grant received under an open application scheme from the Hungarian Financial Supervisory Authority. Indispensable for the implementation of the database was the cooperation extended by operational risk and IT specialists from member institutions throughout the process, from preparations through programme design to testing. The 13 founder banks of HunOR make up 55% of aggregate total assets of the banking sector. **The consortium is open for other institutions to join.**

1.2. MiFID [2] implementation

In relation to MiFID transposition, we submitted the following objections:

The proposed legal solution disregards the fact that the predominant players in the financial market are universal banks, providing a full range of investment services in compliance with the provisions of the Credit Institutions Act and the Capital Markets Act. A major part of the investment funds are subsidiaries of these banks. Most of these credit institutions are controlled by EU-based credit institutions, which, pursuant to their national regulatory frameworks, are subject to compliance on a group basis, in accordance with the relevant EU legislation. The legal guarantee for compliance on a group basis would be common regulation; in contrast, the current legal solution for the implementation of MiFID just further fragments the divergent regulations.

Furthermore, the proposal restructures the current system of definitions. The most disturbing is the proposed introduction of the term "financial instruments" in place of "investment instruments" and the abolition of the category of investment services providers. In the current system, it is clear that the rules for investment firms equally apply to both credit institutions and investment firms. The proposed MiFID legislation only provides rules for investment firms. One reference in the proposal says that these rules are also applicable to credit institutions; another reference says that these rules are only applicable to credit institutions with certain exceptions.

To ensure common regulation, we repeatedly submitted the following proposals:

- There should be one common secrecy legislation; secrecy rules should not be repeated (sometimes with some slightly different phrasing) in other pieces of legislation.
- The Prosecutor's Office should be authorised to access bank secrecy information in respect of civil law cases
- The various licensing procedures provided in the Act on Credit Institutions, the Act on Capital Markets, the Investor Protection Act and the Act on Insurance should be

[2] MiFID: Markets in Financial Instruments Directive

integrated under common principles into the Act on the Hungarian Financial Supervisory Authority and documents required under the various licensing procedures should be specified under an Annex to the Act;

- Amendments to certain rules related to investment fund management, long urged by market players, could be enacted under the proposed amendment to the Capital Markets Act.

1.3 Implementation of the new anti-money laundering Directive

The Hungarian Financial Supervisory Authority set up a working group to address this task. The Association's Compliance Working Group was involved in the working group.

In relation to the proposed new anti-money laundering law, we offered the following conceptual comments:

The identification documents listed in the draft disadvantage Hungarian citizens, given that in their case, passports or driver's licence cards would not be eligible.

We proposed that the rules on beneficial owner be reconsidered. Also, we suggested stipulating in the Act that banks have the right to photocopy the customer's ID documents and to record information required for credit rating without the written consent of the customer.

In relation to beneficial owners, it was mentioned at the competent EBF Committee's meeting that the successful outcome of customer identification is not an obligation: banks should do everything reasonably possible to identify the costumer, however, they should not be held accountable if the identification fails. We consider it as a success that upon our proposals, the relevant legislation as well as the sample rules issued by the Hungarian Financial Supervisory Authority unambiguously provide that non-natural persons may also make a statement on acting in their own name: this relieves banks as well as customers with or without legal entity from enormous administrative burdens. A too rigid beneficial owner regulation would have frightened away these customers from the banking system, thereby weakening the fight against the shadow economy (this range of customers is obliged by law to manage all finances through bank accounts).

Also, we requested that Subsection (3) of Section 1 of the Act on Remote Sales be repealed, to open up the way for financial service providers based in Hungary to perform real remote sales (internet sales, phone sales).

An important achievement was that the reckless form of non-compliance with anti-money laundering reporting obligations was deleted from the Penal Code.

1.4 EU legislation on VAT on financial services

In view of divergent practices in member states and the cases filed with the European Court of Justice and the relevant decisions of the Court, the European Commission launched a review of the VAT treatment of financial and insurance services in 2006. Previously, the Association provided comments on the Commission's working paper. The Ministry of Finance initiated a meeting to update and strengthen cooperation on this issue.

At the meeting, the Ministry gave a brief overview of the latest developments, new working documents (TAXUD/2111/07 Parts 2 and 3) and the timetable set by the Commission, and the details of further cooperation were agreed on. The Ministry requested the banking community's input in relation to the definitions of the various financial services and on agency services and outsourced activities.

The European Commission requested member states to provide a list of concrete products and services based on the four categories provided in the working papers: the relevant lists will be narrowed based on the proposals received. If there are any special Hungarian products (either by description or by contents), they should be indicated to the Commission.

1.5 Proposed legislation on the prohibition of unfair business-to-consumer commercial practices and amendments to related laws

The proposed legislation is aimed at the transposition into Hungarian legislation of the Unfair Commercial Practices Directive (Directive 2005/29/EC). Although the Directive will be adopted under a separate law, the Acts on competition, consumer protection and business advertisements will also need to be amended. For this latter, a new draft law is planned to be drafted, in view of the significant changes required.

The Association commented in several instances on the proposed legislation. In our comments we pointed out that the interrelations with the financial regulatory and supervisory system were unclear, the scopes of authority not clear-cut and the role of the Hungarian Financial Supervisory Authority unsettled. We proposed additions to the definitions. We provided several comments on the proposed amendments to the competition law, in view of the stringent practice applied by the Competition Office. In our comments we proposed a more complex interpretation of consumer information obligations, taking as a benchmark the average consumer, who is reasonably well informed and reasonably observant and circumspect, in line with the relevant EU regulatory practice.

In relation to unsolicited advertisements, we proposed that the previous regulation should be reinstated. In relation to business advertisements we proposed that the legislation should distinguish between awareness-generating advertisements and informative advertisements, with a differentiated regulation of the related obligations.

We proposed that the provisions on advertisements in the Credit Institutions Act be complemented with a provision to say that advertisement should contain information as to where other customer information, as required by law, is made available by the advertiser on the product.

2. Issues related to economic stabilisation and structural reforms

The Association conducted consultations with the assistance of specialists from member banks on the following main issues:

2.1 Corporate tax: proposed tax on impairment and provisions

The Association expressed its opinion that this proposed new tax, affecting credit institutions, was unwarranted. We emphatically drew the Prime Ministers' and the Finance Minister's attention to the risks involved in taxing provisions (weakening Hungarian banks' risk-taking capacity amidst an escalating financial turmoil may lead to a serious confidence loss) and requested that the proposal be withdrawn.

During the consultations on the proposal we insisted that the taxing of impairment and provisions was unacceptable. However, given that the Ministry's representatives had no authority to commit to withdrawing the proposal, we submitted proposals to amend the text of the proposed legislation. The proposal drafted as a compromise would have reduced the tax burden on the banking sector to minimum, but would have posed extra administrative work for banks. Also, a lot of disputes could be anticipated during tax inspections due to the complicated and detailed record-keeping requirements. In view of the very low tax efficiency ratio of expected tax revenues versus compliance costs, the Association continued to advocate for the withdrawal of the proposed legislation.

During the parliamentary debate of the draft law, an MP motion was submitted to revoke the proposed legislation. **At the final vote, Parliament rejected the proposal on the taxation of provisions**. It was agreed with the Minister of Finance that the Association would draft a proposal for the uniform tax treatment of provisions, based on international experience.

2.2 New VAT provisions affecting credit institutions

Based upon EU law harmonisation tasks, the VAT Act was recodified. In the preamble of the proposal it was pointed out that the new law was not intended to change the current VAT rate structure or specific VAT rates for the various activities, but to eliminate current shortcomings of inconsistencies of the legislation, with a view to law harmonisation. In our comments we drew attention that in view of the fact that a number of detail rules and definitions would be omitted in the new legislation, it would be warranted to provide for transitory provisions to avoid legal uncertainty and ensure legal continuity.

We submitted a proposal aimed at ensuring that the specific service types and terms used in daily banking practice and in the relevant sector laws (the Acts on credit institutions and insurance) are incorporated and clearly defined for VAT purposes in the proposed legislation. We sought to assist the drafting team by presenting international examples, handing over banks' internal procedures and providing descriptions of the various facilities. We also drew attention to the fact that the Hungarian translation of the English text was in many instances professionally inaccurate and a term can have different meanings in different contexts in English; we provided references to the relevant international banking terms and practices in use.

After several consultations, a proposal better following the current VAT classifications and more manageable for the banking industry was arrived at. (Changes compared to 2007: custody of physical securities will be subject to VAT, the treatment of consumer credit brokerage is still under review). In addition, we provided proposals in relation to group VAT, the rules for proportioning related to fixed assets, and invoicing. Most of our proposals were incorporated in the new Act.

2.3 Changes related to tax on interest subsidies

Out of the amendments proposed by the Association earlier, a provision was incorporated in the draft law on special tax and tax on interest subsidies to provide that the tax base shall be determined on an accrual basis (rather than on a cash flow basis) and this rule may be applied retrospectively for 2007. Practically, this means that interest subsidy tax advance payments made at the beginning of the year (based on revenues subject to special tax and solidarity tax) can be adjusted in the 2007 returns. Another new, and favourable, rule allows interest differences due to the State to be deducted from the interest subsidy tax base.

The proposed legislation also included a provision that tax on interest subsidies accounted for by mortgage banks as a revenue shall be paid by the credit institution that is the beneficiary of financing, if it is notified by the mortgage bank on the relevant amount in writing. In this relation, we proposed that the splitting of the tax base and the related documentation requirements be regulated in the Act, given that the current provisions on such written notification are imprecise and unmanageable and may give rise to subsequent disputes during tax inspections.

2.4 Other tax changes affecting credit institutions

In view of proposed changes to tax laws affecting the banking sector, the Association's Board convened an extended Board Meeting on October 3. Invited to the Board Meeting were János Veres, Minister of Finance, Álmos Kovács, State Secretary of the Ministry of Finance and Júlia Kiráy, Deputy Governor of the MNB.

At the meeting, the following issues affecting the banking sector were reviewed:

- Proposed tax rules for provisions and impairment
- The proposed new VAT legislation
- Comprehensive Retail Credit Information System
- Implementation of the CRD and MiFID
- Tax on interest subsidies
- Minor taxes: proposed resource-development contribution
- Amendments to the Anti-Money Laundering Act
- Advertisements
- Banks' reporting requirements related to wealth inspections.

Participants found the consultation useful and agreed that besides regulations directly affecting the banking sector, similar top-level consultations would also be useful on comprehensive issues such as the macroeconomic situation, or the drafting of a comprehensive tax reform. Given that banks interact with all economic players, they could share valuable experiences with the government.

3. Proposals on retail banking services

The Expert Committee on Retail banking Services was set up by Government Resolution No. 1097/2006 (X 5) to develop, based on domestic and international experiences, proposals for Government measures aimed at reviewing the current legal framework for retail banking services with a view to improving the quality of retail banking services. The Committee put forward a set of recommendations aimed at promoting competition and improving services. To assess the feasibility of the proposals made, the Association set up eight working groups, made up of specialists from the Hungarian Financial Supervisory Authority, the MNB, the Ministry of Justice, GIRO, the Competition Office and the banking community. The working groups divided their proposals into measures to be taken within the framework of self-regulation and proposals for legislation.

- **Account transferability**

  a) Self-regulation:

  ➯ preparing a guide for changing banks (done by the end of the year),

  ➯ developing a central authorisation management system within GIRO (a legal proposal has been drafted)

- **Basic Accounts**

  a) Self- regulation:

  Developing specific terms and conditions for a basic account facility (including a cap on account management fees), aimed and channelling government allowances to bank accounts.

  b) Legislation:

  Salaries to be transferred to bank accounts on a mandatory basis; restoring the maximum HUF 2000 monthly limit for tax exempt fringe benefits for the use of bank accounts. This proposal seems to be met, given that Government Resolution No. 2233 (XII 12) on additional actions related to the revision of public tasks provides for the preparation of an impact study on the proposal to disburse all social benefits and other allowances provided in money through transfers to bank accounts and to make the requirement of transferring salaries to bank accounts compulsory for all employers.

  Although not ensuing from the Várhegyi Report, it should be mentioned here that the Association made a proposal that start-up supports should be directly disbursed through the banking system without involving the Hungarian State Treasury. This would generate an additional range of customers, with all citizens being Start Account holders as a civic right from birth. We also proposed that all Hungarian citizens in their 14th year of age be assigned an electronic signature by the state.

- **Loan trade-offs and unilateral contract amendments**

  a) Self- regulation:

  ➯ the terms and conditions for early repayment should be specified in the loan contract and remain unchanged during the contract period;

  ➯ changes in terms and conditions (except for interest rates) should be published 30 days in advance (currently 15 days);

  ➯ the forms for outstanding loans should be standardised;

  ➯ the application forms for the cancellation of old mortgages should be standardised.

  (A draft Code for loan trade-offs has been compiled).

  b) Legislation:

  ➯ in the legislation transposing the EU Consumer Credit Directive, a provision should be included to stipulate that a compensation of 3-0.5% (4-0.5% for

mortgage loans) may be charged for early repayment, depending on the loan maturity;
- the regulation on notary public fees should be reformed.

- **Customer information, complaint handling**

  a)Self-regulation:
  - banks engaged in home lending should join the EU Voluntary Code of Conduct on Pre-Contractual Information for Home Loans;
  - banks should develop a detailed complaint handling guide for customers.

  b) Legislation:
  - the legislation on APR should be made more specific (the relevant regulation has been adopted based on the Association's draft proposal);
  - statutory definition should be provided for advertisements and clear requirements for financial advertisements;
  - the definition of usury contracts should be made more specific, and, preferably, interest rates for personal loans maximised in the proposed new Civil Code.

- **Electronic banking**

  a) Legislation:
  - electronic signatures to be the only customer ID accepted;
  - amending the liability rules for electronic payment instruments and bank cards;
  - making the definition for bank statements more specific;
  - making electronic signatures a civic right;
  - amending the Anti-Money Laundering Act.

- **Financial literacy**

  a) Self- regulation:
  - Setting up a Foundation to promote financial literacy. (The MNB has offered HUF 30 million in contribution to launching the Foundation. The Association seeks to join the Foundation as a founder).

  b) Legislation:
  - banks should be allowed to use a part of their vocational training and innovation contributions for promoting financial literacy.

- **Comprehensive Credit Information System**

  a) Legislation:
  - indispensable for the operation of the system is the setting up of a database where all credit information is entered from the moment the loan is made available.

- **New Code of Ethics:**

  A new Code of Ethics to be adopted by the Association within the framework of ***self-regulation.***

At its extended Extraordinary Meeting, the Association's Board reviewed the summary proposal compiled based on the working groups' proposals made upon the Report of the Expert Committee. Participant concluded that the summary reflected the work done was progressive and proposed an appropriate mix of self-regulation and legislative proposals.

The summary document was sent to the Prime Minister, heads of the competent government agencies and the Prime Minister's Commissioner, Gyula Gaál.

Most of the self-regulatory measures proposed are in an advanced stage and can be implemented in the first half of 2008.

4. Activities related to the use of EU funds

Banks reviewed the Economic Development Operational Programmes (seven regional and seven sectoral programmes) developed by the National Development Agency (NDA) with a focus on SME financing. Proposals made by specialists from member banks were mainly aimed at relaxing the conditions to provide a wider range of SMEs access to development funds.

Preparations for the JEREMIE programme:

4.1 Micro-credit B Facility

Banks made a number of comments on the proposed facility during the consultation process. The facility defines those eligible to participate in this facility as enterprises (companies, self-employed entrepreneurs) qualified as micro-enterprises, which are "creditworthy but not bankworthy". This definition refers to the fact that many small enterprises are unable to borrow due to the small amount needed. From this point of view, those micro-enterprises are eligible to participate in the facility, which have had no bank loans for at least six months. (This period was initially proposed to be five years, but banks and professional associations said it should be much shorter).

4.2 Portfolio guarantee facility

The Association organised several meetings with the Ministry of Economy, the National Development Agency (NDA) and the Hungarian Enterprise Development Company. Although agreement was reached on a number of issues, no agreement was reached on the drawdown limit. Initially, the Ministry of Transport proposed a regulation where if 5% of the portfolio is drawn, the guarantee agreement becomes null and void. Appreciating that this was unacceptable for banks, the Ministry now proposes that if the amount of drawdowns reaches 5%, then the guarantee fee should be significantly increased for the entire portfolio. We are opposed to any solution that would affect the conditions of existing contracts. The Ministry of Economy turned to the Hungarian Financial Supervisory Authority to check whether the solution proposed conflicted with the Basel II rules. Banks propose that the guarantee fee should in the above case only be increased for the new portfolio.

Banks were continuously furnished with the proposed application schemes developed by the NDA. The Association to the NDA forwarded Banks’ comments.

5. EPC - SEPA

5.1 Hungarian SEPA organisation

The Association and the MNB had several consultations aimed at setting up the Hungarian SEPA organisation. As a result of the discussions, it was proposed that initially, the organisation should be set up within the current framework of the Payment System Forum, under the joint chairmanship of the MNB and the Association, to develop the National SEPA Implementation Plan and the final framework for the Hungarian SEPA organisation. The joint proposal drafted by the MNB and the Association was adopted by the extraordinary meeting of the Payment System Council, and the National SEPA Implementation Committee, the decision-making body of the new organisation, was set up. The Payment System Forum's Legal Working Group was tasked by the Payment System Council's extraordinary meeting to develop the National SEPA Implementation Organisation's Statutes and to modify the Payment System Forums' Operational and Organisation Rules, as appropriate.

5.2 SEPA Online Payments Rulebook

Alongside with the basic SEPA payment schemes (SCT, SDD, SCF), the drafting of the Online Payments Rulebook commenced. An ad hoc working group made up of specialists from banks and members of the Payment System Forum’s Mobile Working Group reviewed the SEPA Online Payments proposal sent for comments. In its comments, the working group expressed its opinion that the described model does not seem to offer consumers any extra benefits over card payments. The working group also identified some security issues in the transaction chains that may raise phishing concerns. It also mentioned it as a problem that the transaction day and its deadline were unclear.

We drew attention that apart from the logical model, it is crucial that the business models for the various online payment methods are also developed in details. We pointed out that matching the current domestic banking and account management systems with continuous, 7/24, online systems is a task involving substantial investments.

6. Other professional issues

6.1. Ministry of Finance rulings

6.1.1 Duty on capital increase

At banks' initiative, the Association asked the Ministry of Finance to provide its position in the matter of duty on capital increase, given that in cases where the issue price is higher than the face value and the difference between the issue price and face value is accounted for as retained earnings, the legislation is not clear-cut on whether or not this difference (premium) is qualified as transfer of assets free of charge subject to duty and if so, what the duty rate is.

According to the Ministry's response, capital increase is considered as a recourse transaction, however, the provisions on transfer of assets with recourse do not apply to money, as movable property, therefore, and it is not subject to duty. At the same time, the Ministry drew attention that free asset transfers between companies are subject to donation tax.

6.1.2 Tax on interest subsidies

The Association turned to the State Secretary of the Ministry of Finance in the matter of a tax risk related to the tax on interest subsidies imposed effective from January 1, 2007.

The issue affected banks selling loan products that were not eligible for interest subsidies when approved and were subsequently associated with interest subsidies. In these cases, the question was how the tax liability was to be interpreted for interest received prior to the loan becoming a subsidised loan.

6.2 Proposals aimed at revising and simplifying tax laws

6.2.1 Act on Corporate Tax, Social Security Act

The Association proposed several adjustments to the texts of the Act on Corporate Tax and the Social Security Act. In relation to corporate tax we proposed that the provisions on tax-deductible local trade tax should be made more specific, given that for banks and other businesses with large networks, the withdrawal of tax allowances upon minor tax shortfalls is disproportionately high. In the case of large regional networks, communications with municipalities require extensive correspondence (without any electronic communication channels) and tax account reconciliation by mail.

Another practical issue was related to monthly tax returns. Namely, there is no possibility to include negative items in the monthly tax returns as per Subsection (1) of Section 50 of the Social Security Act. Accordingly, in the case of persons leaving or retiring mid-year, pension contributions refunded due to the contributions cap must be recalculated retrospectively for several months. Adjusting the respective monthly tax returns is an extra administrative burden, in addition to the fact that no base report to show the actual adjustments for future reference remains. To simplify the process, we proposed that the reporting requirements and the relevant provisions of the Social Security Act be revised.

6.2.2 Electronic tax returns

At banks' initiative, we proposed to the Tax Office that its IT system for electronic tax returns should be enhanced.

To improve user control and data identification, we proposed that electronic identification codes should be included in the downloadable reports. Also, we requested that online reports be also made available in a format suitable for further processing (excel), in addition to the read-only Acrobat format. The competent unit of the Tax Office was supportive of our proposals.

6.3 Advertisements - fines imposed by the Competition Office

The Competition Office often imposes fines on banks for what is considers as misleading advertisements. To successfully challenge these decisions in court and to achieve a legal interpretation that is favourable for the banking community, we took up the matter with the Advertising Association. The Advertising Association is also interested in avoiding the need to clutter up advertisements with irrelevant information, indigestible for the customer, due to the Competition Authority's misinterpretation of the legislation.

The Association's Board decided that work launched based on proposals made by the working groups in response to the Várhegyi Report should continue, irrespective of when a response from the competent government bodies was to be expected. An important decision proposed by the Customer Relations Working Group was to have the notion of awareness-generating advertisements be accepted by the authorities and the professional community.

The working group concluded that the legal legitimacy of awareness-generating advertisements cannot be derived from current legislation (the Credit Institutions Act and the Advertisements Act), and neither the Competition Office's nor the Court's practices provide clear guidance in this respect. In the meantime the Hungarian legislation implementing the EU Unfair Commercial Practices Directive was submitted to inter-ministerial review. We reiterated the industry's position during the review, but up until now we have not been able to convince the Competition Office's representatives attending the review.

The only progress on the issue was that the Competition Office's representatives attending the consultations understood the issues raised by the banks and were of the opinion that the current regulations and the laws to be enacted will together be able to tackle the issue of awareness-generating advertisements and ensure that those trying to abide by the law will be able to avoid fines for misleading advertisements.

6.4 Comprehensive credit information system

Work aimed at developing a Comprehensive Credit Information System continued in the inter-ministerial preparatory committee, headed by the Ministry of Justice. A guiding principle for this work was that the individual's right to dispose of his/her data can only partially be limited and such limitation should not prejudice the effectiveness of the system.

Accordingly, after several rounds, the working committee put forward the following proposal: indispensable for the system's effectiveness is a database, where all credit information is entered from the moment the loan is made available. Although the compilation of such a database is considered as data processing (subject to licensing if otherwise not authorised by law), it is indispensable for the efficiency of the system.

The system would allow the borrower to authorise the future maintenance of information on his/her repaid loans (ultimately, this would strengthen his/her position during a future loan application).

The Justice Ministry's concept of the proposed Comprehensive Credit Information System is expected to be tabled to the Government in April 2008.

6.5 Amendments to the APR regulation

The Ministry of Finance sent for review the proposed amendments to Government Decree No. 41/1997 on Annual Percentage Rate and Annual Percentage Yield in September. The proposed amendments were drafted based on the proposals provided by the Association's APR working group under its response to the Várhegyi Committee report. The Ministry complemented these with proposals regarding Annual Percentage Yield for deposits and debt securities.

Based on banks' proposals and comments, the Association held several consultations with the Ministry. Most of our proposals were accepted. In some cases, the Association had to develop a common position to ensure consistent interpretation and application.

6.6 Amendments to the Government Decree on Home Loans

The Ministry of Local Government and Regional Development proposed several amendments to Government Decree No. 12/2001 on Home Loans. The proposal provided an opportunity to reconsider issues accumulated over the years.

Based on the Ombudsman's proposal, the regulators sought to tighten the provisions for banking operations related to state subsidies in terms of customer information, appraisal time, explanation for rejection and applicable fees. While not challenging the underlying reasons for the regulation, banks made several proposals to make the regulation more specific and workable.

Although well-aware of the tricks for evading own resource requirements, banks did not support the provision that own resource may only be paid by bank transfer: this would be impracticable, given that most of those concerned do not even have a bank account.

In our comments we welcomed the proposal to impose sanctions on recipients of state subsidies failing to report changes in their social circumstances or in their eligibility within the prescribed time. Almost all commenting banks pointed out that the apartment price limits for eligibility for subsidies should be increased to reflect current market prices.

At the Association's request, the Ministry of Local Government and Regional Development organised a consultation to review the comments and questions received. At the consultation, attended by a great number of banks, issues raised by banks were discussed in details; a number of proposals made by banks were promised to be taken into account.

6.7 National Deposit Insurance Fund membership fees

At the National Deposit Insurance Fund's Board Meeting, at the Association's proposal, annual membership fees were halved in view of the excess cover provided by current fees. As a result, HUF 1 billion reduced the aggregate amount of annual membership fees payable by banks.

6.8 New Civil Code

The Association organised a consultation with the officer responsible for drafting the legislation related to the collaterals system in the proposed new Civil Code. The consultation addressed a number of practical issues related to the filing of lien: the foundation of new condominiums, lien on bank account receivables, lien on future receivables, floating charge, the status of the lien representative in syndicated lending, incorporating security deposits in the lien law.

A consultation was held at the Association in September with the State Secretary of the Ministry of Justice to review the issue of financial contracts. Based on banks' comments, the Association provided text proposals for provisions of the chapter on financial relations.

6.9 Proposed amendment to the Bankruptcy Act

The Ministry of Social Affairs and Labour sought to amend the Bankruptcy Act under its law package on certain labour laws and other related laws. The main objective of the amendment was to reinstate the previous 50% limit in place of the provision providing for a 100%

satisfaction of lien holders' claims effective from January 1, 2007. The Association reacted firmly against the proposal. We presented our counter-arguments to the Prime Minister and the Ministries involved, as well as at the inter-ministerial review and in the business press. The Ministry of Economy and Transport and the Ministry of Finance also supported our position. So did the Justice Ministry, which was opposed to the proposal from the outset. In the end, the proposal was dropped.

6.10 Rules of procedure for the provision of state guarantees

The proposed amendment to Government Decree No. 110/2006. (V.5.) on the rules of procedure for the provision of state guarantees was aimed at updating the Decree to be consistent with the recently amended Act on Public Finance and modifying certain provisions of the Decree, based on practical experience. We submitted a number of comments aimed at making the provisions of the Decree more specific, in particular in relation to the sample contract. Furthermore, we requested that the deadlines be extended in view of practical requirements and in accordance with the relevant laws. Our proposals were only partly accepted: some of the deadlines were omitted; special requirements may be addressed in the specific contracts, this is allowed for by the legislation.

6.11 Proposed legislation on annuity provision and annuity providers

The Ministry of Finance for review furnished the proposed law in March 2007. This legislation is aimed at regulating the relationship between businesses providing annuities on a commercial basis and their customers and at providing for the relevant supervisory framework. Under life annuity contracts, the annuity provider acquires ownership of the customer's real estate and in exchange pays the customer a life annuity. Pursuant to the proposal, a precondition for this activity is a minimum HUF 500,000 in share capital. The activity is supervised the Hungarian Financial Supervisory Authority.

The Association provided several comments on the proposal. We proposed that banks and insurance companies also be allowed to engage in annuities activities. We proposed that the transfer of ownership of the customer's real estate should not take place upon conclusion of the contract and that the relationship between the proposed legislation and the Bankruptcy Act should be reviewed, given that, failing any other provisions, in case of a liquidation procedure instituted against the annuity provider, the customer's real estate will be included in the assets under liquidation. We proposed to include more substantive law provisions for annuity provider activities in the proposed legislation. We drew attention to the combined effect of life insurance and real estate risks and in view of this, proposed that the minimum initial capital requirement should be revised. We also proposed that in respect of land registration, the Act the Act on Land Registration should be amended.

6.12 Regulatory amendments aimed at enhancing the security of legal transactions

The proposed amendments allow lawyers, notaries public and bailiffs’ online access to databases of the Central Office for Administrative and Electronic Public Services (formerly: Ministry of Interior Central Office). Lawyers will be obliged to deny services to clients who refuse to provide identification data and show valid identification documents, or if during verification they find that the ID documents presented are registered in the lost and stolen documents registry.

The draft law amends the rules for drafting notary deeds and specifies the requirements regarding real estates used as registered offices. At the initiative of the banking community, the proposal cancels the provision of the Civil Code that requires two authorised signatories for disposing of banks accounts of legal entities.

We provided several comments on the draft law. We proposed that legal counsels also be given access to the personal databases. We drew attention to the discriminative treatment of legal counsels in business legislation experienced in recent years. We raised that consulting the databases should be an obligation, rather than an option. We also proposed that business organisations, especially those engaged in financial and investment services, should also be provided with access to the databases. Furthermore, we made proposals for adjustments to certain provisions of the Bankruptcy Act and the Civil Code

~~6.12~~6.13 Reporting

6.13.1 Central bank reporting

Banks' reporting officers reviewed the central bank's proposed reporting requirements for 2008 and their questions were answered at a meeting organised with competent officers of the central bank.

An important element from the point of view of reporting is that until the Credit Institutions Act is amended to ensure consistency with the new CRD, the Hungarian Financial Supervisory Authority will accept the common supervisory balance sheet structure compiled by banks in its current form and the reporting deadlines will not be reduced.

There was a debate over the proposed new structure and increased data requirements for the portfolio and interest reports on retail loans (APR on the full stock of loans). The Association proposed that a working group, made up of members from the central bank and member banks should be set up, and requested that the introduction of the new reporting requirements be reconsidered and postponed.

Taking note and appreciating the comments made, the MNB decided to drop the plan of introducing the new requirements in 2008. The MNB is supportive of the proposal to set up, jointly with the Association, a working group to develop the methodology for generating the new APR to be calculated on the full stock of loans. Seven banks indicated their intention to participate in the work, aimed at introducing the new reporting requirements from 2009.

Banks raised the issue that the proposed change in payments reporting (switching from account turnover reporting to payments turnover [transaction level] reporting). The Association conducted a survey, which revealed that the development costs required for implementing the new reporting system would be in the range of HUF 60 to 80 million at sector level. Banks would be able to shift to the new system gradually during 2008, with all banks ready for implementing new system by the end of 2008. Based on this survey, the MNB decided to allow banks to shift to the new reporting system during 2008 at a date to be decided by them and indicated to the MNB in advance (instead of January 1, 2008).

At the Association's request, the MNB gave a briefing on issues related to answering the methodology questionnaire of the European Central Bank.

6.13.2 Hungarian Financial Supervisory Authority reporting requirements

In view of the European and Hungarian capital requirements legislation, the Hungarian Financial Supervisory Authority's reporting requirements will change in both structure and contents from January 1, 2008. The Supervisory Authority sent for review its working document on the proposed reporting tables ahead of the transposition of the CRD into Hungarian legislation. We proposed that the date from which banks should fully meet the new reporting requirements related to the new capital requirements legislation should be set as July 1, 2008, and the Supervisory Authority should only solicit those data which are absolutely necessary (regulatory capital, minimum capital requirements according to the approach used), given that banks need time to prepare the necessary reporting tables and system correlations.

Banks provided detailed comments concerning the proposed reporting tables. The Supervisory Authority offered to give banks the opportunity to test the new data and table correlations in practice.

6.13.3 IASB - IAS/IFRS annual improvements project

At a press conference held at the beginning of October, the IASB, the IAS/IFRS standard-setting body, announced its decision to publish annual proposals for minor amendments to the IAS/IFRS within the framework of an annual improvements process. The objective is to collect and deal with minor changes, which are time consuming for the Board and hinder consistent application of the standards. Such non-urgent but necessary amendments may include minor changes to remove redundant transitional provisions, or minor changes to the wording to clarify the meaning and to remove unintended inconsistencies between IFRSs.

In October each year, an omnibus exposure draft of the collected proposals will be published for public comment, with a comment period of 90 days. After the IASB has considered the comments received, it will issue the amendments in a final form in the following April, with an effective date of January 1 of the following year. The annual improvements process is aimed at easing the burden for all concerned by packaging non-urgent, but necessary, minor amendments to standards into a single document, rather than involving a series of piecemeal changes.

III. ASSOCIATION LIFE, EVENTS

~~1.~~1. Conference on the 20th Anniversary of the two-tier banking system in Hungary

The Association organised a conference on the 20th Anniversary of the two-tier banking system in Hungary. The conference was titled "Tasks and challenges - the Hungarian banking system from a Hungarian and international perspective". The objective of the conference was for the government to receive direct input from foreign owners of Hungarian banks on foreign expectations in terms of economic policy and for foreign owners to be briefed on the objectives the government pursues on the path of economic stabilisation. At the conference, the Prime Minister, Ferenc Gyurcsány, delivered a lecture on the road of reforms and sustainable economic growth. János Veres, Minister of Finance, gave a presentation on economic policy objectives and Hungary's convergence programme. András Simor, Governor of the Hungarian central bank spoke about the targets and instruments of monetary policy. Representatives of parent companies of banks operating in Hungary spoke about their experiences and new challenges in the Hungarian banking market. The Secretary General of the European Banking Federation reviewed tasks and challenges for the European banking community. The conference provided a comprehensive overview of changes over the past 20 years and tasks for the near future. (The presentations delivered at the conference are available on the Association's website www.bankszovetseg.hu /Rendezvények, előadások).

~~2.~~2. Press conferences

At the press conferences held on June 13 and December 3, the Association's President and Secretary General gave presentations on macroeconomic developments and current issues affecting the banking sector. At the December press conference, journalists, inter alia, asked questions about what impacts the U.S. sub-prime market crisis might have on the Hungarian economy.

~~4.~~3. MiFID consultation

Transposition of the new Capital Markets Directive into Hungarian legislation arrived at its final stage. The Association organised two workshops on this issue. At the workshops, attended by a great number of participants, banks exchanged views on EU-based parent banks' experiences. Several complaints were raised regarding legislation: participants criticised the lack of consultations and the fact that the Ministry of Finance often failed to meet its own timetable. Meanwhile, participants also agreed that the proposal has improved significantly during the reviews.

The issue of investment consultancy was reviewed at a special workshop: the presentation held by the representative from the Association of Securities Dealers can be a good starting point for banks providing investment services in developing their relevant practices.

~~3.~~4. Foreign Bankers' Club

At the Foreign Bankers' Club meeting of October 4, attended by 12 banks and Csaba Varga, Director General of the Hungarian Financial Supervisory Authority, the Association's President briefed participants on the meeting held with the Minister of Finance on October 3 on issues affecting the banking sector, including the proposed tax on impairment and provisions, the planned Comprehensive Retail Credit Information System and the status of implementation of the CRD and MiFID in Hungary.

Under the second agenda item, the main objectives laid down in the report of the expert group on improving the standards of retail banking services, the ensuing tasks for banks and the related submission to the government were discussed.

~~6.~~5. Conference on 2008 tax changes affecting credit institutions

On November 30, the Association organised a one-day conference for banks' tax officers on 2008 changes in tax laws. Invited to the conference was a Finance Ministry staff involved in drafting the legislation and tax consultants from PricewaterhouseCoopers.

The objective of the conference was to highlight tax changes affecting financial services and discuss the related issues. In addition to changes in Hungarian tax laws, participants also inquired about latest developments related to the proposed revision of the EU VAT Directive. The presenters also tried to answer questions received by the Association from member banks, and the Finance Ministry's representatives promised to answer the more complex issues in writing after consultations within the Ministry. In addition to changes in the Act on Personal Income Tax and the Act on the Rules of Taxation, the interpretation of new provisions of the VAT Act effective from 2008 was given special attention. Both participants and presenters found this opportunity of personal consultation useful.

~~5.~~6. Conference organised by the Ad Hoc Parliamentary Committee on Consumer Protection

The Association was invited to a conference organised by the Ad Hoc Parliamentary Committee on Consumer Protection. The conference adopted a closing statement. Although the main apropos for this conference was the recently seized large volume of foods with expired dates, relations with this Committee (which is expected to be transformed into a Standing Committee) may be important in the long-term.

~~7.~~7. Working Committees

7.1 Working Committee on Macroeconomy

At its meetings in 2007, the Working Committee on Macroeconomy reviewed the situation of international financial markets, analysed the macroeconomic situation and evaluated the performance of the Hungarian banking sector. The positions developed at the Committee's meetings were used as background documents for the Association's press conferences.

7.2 IT Security Working Group

At the May meeting of the Working Group, Péter Rónaszéki from ING Bank was elected head of the IT Security Working Group and thus became Deputy Chairman of the IT Security Committee. IT Security Working Group's tasks in 2007 included cooperation with the government's IT incident management centre HUN-CERT[3], participation in drafting a supervisory recommendation for security solutions for electronic sales channels, developing a

[3]HUN-CERT: Hungarian Computer Emergency Response Team

framework for cooperation with the Hi-Tech Crime Unit of the National Police Headquarters and developing solutions for the verification and protection against forgery of bank account statements.

7.3 Physical Security Working Group

The Association's Physical Security Working Group reviewed in detail the data reporting requirements of the EBF, given that these data serve as a basis for comparison between Hungarian and international bank robbery statistics. Unfortunately, the statistical categories used by the Hungarian Police are different from those used by the EU, and therefore, are of less use for banks.

The working group evaluated the relations with the Police as positive, with the police providing full cooperation and taking prompt and efficient action in emergency situations. Good progress was made in the "Robo-Cop" programme, under which police arriving at the scene are provided by the bank with full and up-to-date, real-time information. Testing with the two banks involved in the programme is close to completion. The programme will soon be available for other banks to join.

The Working Group also addressed the possibilities for reducing crime reporting requirements and the Hungarian Fire Service's licensing practices, detrimental to banks. The Working Group expects action from the Association and the Group's management in both issues.

7.4 Compliance Working Group

The Working Group met on an almost weekly basis to review the various versions of the proposed new anti-money laundering legislation. Representatives attended the August meeting from the Ministry of Finance.

7.5 Fraud Working Group

At the Fraud Working Group's meeting, detectives from the National Investigation Office gave a briefing presentation on a series of fraud cases committed with forged documents against banks.

IV. INTERNATIONAL COOPERATION

1. Banking supervision - Regulation - Capital Adequacy

1.1 EU developments

The competent EU bodies adopted several Directives related to banking regulation in 2007. In the first half of the year, the European Parliament and Council passed in first reading the **Directive on supervisory approval of mergers and acquisitions.** In May, the European Commission launched a public consultation on the **Directive on the reorganisation and winding up of credit institutions** (Directive 2001/24/EC). The consultation took place in the context of the review of EU supervisory arrangements, which focuses on the key challenges to the current framework, including liquidity risk management, lender of last resort, crisis management and deposit guarantee schemes. The results of the review will be incorporated into the European Commission's report to the European Parliament and the Council on the implementation of the Capital Requirements Directive (Directive 2006/48/EC) at the end of 2011.

The review of the **future of banking supervision in Europe** is a main theme of the European Union. The European Parliament held a debate on this topic. The institutional framework for future banking supervision in European was also addressed in the IMF report on euro-area policies. Among the various alternatives, the single European supervisor model and the two-tier supervisory model were also raised on the various European forums addressing the issue.

The European regulations on **liquidity risk management and large exposures** are also key issues in EU legislation. The CEBS[4] received calls for technical advice from the European Commission on both issues. Also, the Commission requested **technical advice from the CEBS on third country supervision** (equivalence of consolidated supervision in Switzerland and the USA).

According to plans, results of the CEBS advices may be taken into account in the planned revision of the CRD in October 2008. Implementation of the CRD in the various member states revealed a number of technical, formal and content issues. These should be corrected as soon as possible. According to the European Commission, some of the problems raised can be tackled within the framework of the CRDTG[5]. Adjustments to Annexes of the CRD can be carried out under a comitology process, revisions to the main text, subject to co-decision by the European Parliament and Council, are expected to be enacted in the autumn of 2008. The provisions on the treatment of large exposures and hybrid capital instruments are also expected to be included in the CRD during this process. The Commission plans to carry out a major review of the CRD in the second half of 2009.

The various forums of the European Union addressed and published reports on several issues affecting banking and financial regulation, including the ECON's own initiative report (the **van den Burg Report)** on the European Commission's Financial Services Policy White Paper 2005-2010. In this report, the European Parliament urges for consistent implementation of the Financial Stability Action Plan (FSAP).

[4] Committee of European Banking Supervisors
[5] CRD Transposition Group

The European Parliament's report on deposit guarantee schemes basically shared the European Commission's view that legislative amendments to the Directive should not be undertaken at this point and that the operation of deposit-guarantee schemes should be supported through self-regulatory measures to be developed in cooperation with the EFDI[6].

Other EU documents related to banking supervision include the European Parliamentary Financial Services Forum's (**EPFSF**[7]) **briefing paper on consolidated supervision** and the **IIMG*[8]*'s** final report on the Lámfalussy process (for more on these reports see the Association's quarterly reports on activities).

1.2 Measures in response to the financial turmoil

Several initiatives were made in the EU to tackle the financial turmoil caused by the U.S. sub-prime crisis and to develop potential regulatory measures. At the beginning of October, the German Chancellor, Angela Merkel, the French President, Nicolas Sarkozy in a joint statement called upon the ECOFIN to identify any regulatory or non-regulatory actions needed to respond to the situation. In response to this call, the **ECOFIN**[9] in the same month agreed on a **roadmap**, identifying the key issues to be examined.

The Financial Stability Forum's Working Group on Market and Institutional Resilience in October prepared a **preliminary report** on the financial turmoil to the G7 Finance Ministers. The report is to be finalised by the April G7 meeting. The actions identified in the report (taking measures to obtain the data and analytical resources necessary to strengthen valuation approaches for structured finance products, enhancing disclosures about own risk exposures, and making collaborative efforts to put the funding of structured investment vehicles on a more secure footing) coincide with those actions identified in the ECOFIN roadmap. The Working Group also highlights the importance of efforts made by industry associations to underpin financial stability.

The **IOSCO*[10]* Task Force on the sub-prime crisis** was set up in Tokyo in November 2007. The Task Force will be active until the stability of credit and financial markets is restored. The Task Force will provide input to the Financial Stability Forum. .

In December, the European Commission convened a **roundtable on improving transparency in structured credit markets,** aimed at promoting market-participant driven solutions.

The roundtable addressed three issues:

- Whether there is a need to strengthen Pillar 3 or other disclosure requirements;
- How can transparency in structured credit markets be improved;
- Whether there is a need to improve valuation methods.

Following the roundtable, the European Commission and industry representative developed a work plan with 14 tasks. Work for improving transparency in structured credit markets will continue in 2008.

[6] European Forum of Deposit Insurers
[7] European Parliamentary Financial Services Forum
[8] Inter-institutional Monitoring Group
[9] ECOFIN: the council of European Finance Ministers
[10] International Organisation of Securities Commission

At a request from the European Commission, CESR[11] is reviewing some additional issues related to the **IOSCO Code of Conduct**; in particular, the role of credit rating agencies with regard to structured finance. Based on this survey, CESR will decide whether self-regulation by credit rating agencies is sufficient or a regulatory regime would also be needed. Public consultation on the issue will be conducted from mid-February to the end of March. CESR is expected to present its final report by the end of May. The European Committee requested a similar advise from the European Securities Markets Expert Group (ESME), also by the end of May.

Also, the British Banking Association in December published recommendations regarding financial stability, regulatory coordination and issues in the international mortgage backed securities and credit markets. The British Banking Association considers that to rebuild confidence, it is important to make it easier to differentiate between mortgage-backed securities backed by prime mortgages and those, which are not. This includes a need for more information and transparency.

1.3 Committee of European Banking Supervisors (CEBS)

The CEBS carried out its activities according to its Work Programme. Within the framework of regulatory advise based on the European Commission's call for technical advice, the **report on commodities firms and the prudential supervision of commodities business** was published in January and, as a second part of the advise, the **report on risks arising from commodities business and from firms carrying out commodities business** in October.

A comparison of **capital requirements for banks and insurance companies and the eligible elements to cover the capital requirements**, compiled jointly with CEIOPS[12] was published in January. The second part of this report, **the report on the impact of sectoral differences in the definition of capital instruments for financial conglomerates** was published in August. Also in the context of this technical advice, a **quantitative analysis of hybrid instruments eligible as original own funds** was published in March 2007. The CEBS presented the results of the work aimed at examining the **economic nature of hybrid capital instruments** at the public hearing of November 22 and published its relevant proposals on December 7. Work within this scope included the **public hearing on further convergence on own funds in Europe**, held on June 11, 2007, the **quantitative survey of eligible own funds** and **the public hearing and report on the application of prudential filters for regulatory capital**.

The **technical advice on large exposures** included the following milestones in 2007: the CEBS received the European Commission's second call for technical advice in January. The first part of this consultation (CP 14), addressing the prudential objectives of large exposures regulations and examining the purpose and benefits of the aggregate limit on large exposures was issued in June. A public hearing on the issue was held in July. Based on comments made at this hearing and those received after the consultation, the final document of the first part of the technical advice was submitted to the European Commission in November. The CEBS stresses that the current 800% aggregate limit on large exposures should be kept and may not be replaced with the requirements for the management of concentration risk under Pillar 2. The consultation on the second part of the technical advice addresses the definition of large

[11] Committee of European Securities Regulators
[12] Committee of European Insurance and Occupational Pensions Supervisors

exposures, the definition of exposure value, the recognition and reward for good credit management, the treatment of mitigation, the treatment of intra-group exposures, the treatment of interbank exposures and the levels of application (individual versus group-level), the appropriateness of a one size fits all approach, and issues related to the reporting regime. (A public hearing on large exposures was held on January 15, 2008. The consultation period ran until February 22, 2008).

At the beginning of March the CEBS received a call for technical advice from the European Commission on liquidity risk management. The purpose of the call is to promote regulatory and supervisory convergence at the EU level and to identify those issues, which may require changes in the regulatory framework. The advice was provided in two steps, in July and in August. The European Commission requested the CEBS to focus on the identification of issues and not to provide possible solutions to them at that stage. In August, the CEBS published the first part of its technical advice. The first part of technical advice included a survey of the current regulatory frameworks and answers received from member states to the questionnaire. The CEBS held a consultation with industry representatives on liquidity risk management in September. In light of the uncertainty created by the U.S. sub-prime crisis, supervisors questioned the sufficiency of the internal risk management methodologies proposed by the industry.

Two additional calls for technical advice were received from the European Commission: one on the **reduction of national discretions and options** (deadline for advice: May 2008), and another on the **equivalence of supervisory arrangements and supplementary supervision in Switzerland and the United States** (a joint technical advice with CEIOPS).

Aimed at promoting supervisory convergence, in 2007 the CEBS published a consultation paper on the establishment of a mediation mechanism between banking supervisors (CP 13) and a consultation paper on amendments to its own supervisory practices (CP01rev). After public consultation, the amendments to the CEBS Guidelines on Financial Reporting and the protocol for a mediation mechanism between banking supervisors were published. Also, public consultations were launched on the medium-term work programme of the 3 Level 3[13] Committees and on amendments to the CEBS Guidelines for Common Reporting (this latter includes a proposal for the harmonisation of remittance dates and reporting frequencies). A report was compiled and a public hearing held on issues related to supervisory convergence.

Workshops organised by the CEBS included the workshop held jointly with the ECSA[14] on issues related to proportionality under the CRD and the CEBS workshops on the streamlining of reporting requirements (COREP) and on Pillar 3 implementation. The CEBS's Operational Networking platform, maintained by industry representatives, in June published a list of deliverables aimed at improving the performance of European banking supervisors.

1.4 EBF

Operations of the European Banking Federation's Banking Capital Adequacy Working Group (CWAG) continued to be focused on work within the EU and the CEBS. The EBF was involved in all consultations and communicated the industry's position on all issues addressed, initiating also bi-lateral consultations, where appropriate.

[13] CEBS, CESR, CEIOPS
[14] European Credit Sector Associations

The EBF's Capital Adequacy Working Group carried out extensive work on compiling a list of errors identified in the CRD and making proposals for their correction and on reducing national discretions and options.

In connection with Pillar 3, the EBF's Banking Supervision Committee and Accounts Committee set up a joint subgroup to identify issues related to supervisory disclosure requirements and to develop a lobbying strategy on the issue. The application of disclosure requirements to subsidiaries was identified as the most problematic issues.

The EBF, together with two other European credit associations set up an ad hoc working group to develop minimum standards for liquidity risk management in less sophisticated banks. In its letter to the European Commission, ECB and CEBS, the EBF made several proposals regarding the regulatory principles of liquidity management.

The EBF provided detailed opinions and comments on the CEBS's proposals related to the establishment of a mediation mechanism between banking supervisors, amendments to the Directive on the liquidation and reorganisation of credit institutions, and the Solvency II Directive on capital requirements for insurance companies. It also provided comments on activities of the 3 level 3 committees. It initiated the reduction of reporting burdens. It wrote a letter to the CEBS and CEIOPS on the need for a uniform treatment of hybrid capital instruments in the banking and insurance sectors, and later in this context, expressed its objection to the fact that the banking industry's position on hybrids that can be included in Tier 1 capital was ignored in the CEBS's preliminary report. In connection with the proposed U.S. regulation[15], the EBF provided a thorough opinion, sharing the position of the European Commission and urging for compliance with Basel II.

An outstandingly important project of the EBF is the work on the future of banking supervision in Europe. The Task Force set up for this purpose is charged with grounding the EBF's position by assessing the various supervisory models. The Report on Integration of Financial Services Markets, published in December, is the perhaps the largest project the European Banking Federation has undertaken in recent years and is a result of joint work of all committees of the EBF. (The report will be available in Hungarian in the Association's publication *Hitelintézeti Szemle).*

1.5 U.S. developments

In July, the U.S. regulatory agencies[16] reached agreement on pending issues related to Basel II implementation. Accordingly, the proposals for a 10% system-wide limitation (the decline in regulatory capital ratios may not have exceeded 10% as a result of the new rules) and the introduction of Basel IA were dropped. Meanwhile, the leverage ratio and the institution of prompt corrective action (PCA) were retained.

On November 2, the final rules for implementing Basel II advanced measurement approaches (IRB, AMA) in the U.S. were published. The regulation is mandatory for those large internationally active banks with at least $250 billion in total assets or at least $10 billion in

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[15] Notice of Proposed Rulemaking
[16] Office of the Comptroller of the Currency, Federal Reserve System, Federal Deposit Insurance Corporation, Office of Thrift Supervision.

foreign exposure (core banking organisations). All non-core banking organisations will apply the standardised approach; these are to be published at the beginning of 2008.

Based on the comments received, the final rules were changed substantially compared to the original proposal. Most changes mean a return to the Basel II Accord, a positive move from the point of view of ensuring a level playing field.

1.6 Basel Committee documents

The Basel Committee issued fewer documents on Basel II in 2007. This was probably due to the fact that the standardised Basel II approaches have in the meantime been adopted in several member states. Documents published by the Basel Committee in 2007 included:

- Principles for home-host supervisory cooperation and allocation mechanism in the context of Advanced Measurement Approaches (consultation paper in February and final document in November 2007)
- Progress on Basel II implementation, new workstreams and outreach (May 2007).
- Guidelines for Computing Capital for Incremental Default Risk in the Trading Book, BIS 12 October 2007

Assessing experiences in Basel II implementation, the Committee concluded that the Accord Implementation Group (AIG) on home-host issues, especially regarding Pillar 1 (minimum capital requirements), has made significant progress. Tasked to promote consistent implementation and supervisory convergence, the AIG will now focus on the other two pillars: supervisory convergence and disclosure requirements.

The Committee's new areas of review include liquidity regulation, the definition of capital and application of the economic capital model. The Committee considers it important that non-EU member states, representatives of the banking industry and other stakeholders are involved in its work from the outset.

2. EBF Committees

2.1 Fiscal Committee

The EBF Fiscal Committee reviewed the EBF's proposals aimed at a revision of the EU VAT Directive. In the EBF's opinion, a comprehensive reform that addresses the aspects of legal certainty and non-neutrality is required.

The EBF's position is that timing is important but even more important is a Directive that is acceptable to the financial industry is adopted.

2.2 Accounts Committee

The EBF Accounts Committee reviewed those theoretical and technical issues that might arise if all instruments were to be reported on a full fair value basis. Financial reports should provide comparable, reliable and comprehensible information on a company's performance and financial position to users, including business decision-makers, creditors, investors, analysts, employees and regulators.

Members of the working group agree that it is not possible to create a single report that contains all information required by all users; therefore, users should be provided with access to supplementary information in addition to the information provided in the financial report. The model to be used in full fair value measurement should be selected based on the specifics of the business, its strategy, the tools applied in its operations and its types of liabilities. Full fair value measurement does not always reflect future cash flows, for example: for financial assets held to maturity, long-term fixed-interest assets and non-marketable instruments. Future cash flows for these instruments can be better forecast at amortised cost.

Some sort of a mixed method should be sought, where the various components are measured by taking into account the business objective. There are various banks, using various business models and various strategies. Accordingly, a varied approach should be adopted. In view of this, the working group would prefer a proposal that would further develop the current mixed method by further improving the full fair value option or the hedge accounting rules.

2.3 Payments Committee

The EBF Payments Committee reviewed issues related to the launch of SEPA at the beginning of 2008 and adoption in national legislation of the EU Payment Services Directive, affecting SEPA. The international exchange of views revealed that although banks in the euro-zone are ready for the launch of the SEPA Credit Transfer Scheme in January 2008, there were still uncertainties in the areas of customer information, the readiness of government agencies and the state of clearing systems in the various member states.

Implementation of the SEPA Direct Debit Scheme will be a major change. The legal continuity of authorisations and account contracts is already a major issue in the course of preparations.

In relation to the card payments framework, the banking community challenged the EU authorities' (in particular, the ECB's) pushing for a European card. Banks believe that this is a politically motivated effort, given that the SEPA Cards Framework favoured by banks and supported by the EPC is more advantageous for banks.

The Committee attaches great importance to the adoption of the EU Payment Services Directive (PSD) in national legislation: its implementation and consistent interpretation of its definitions and provisions can greatly contribute to the success of SEPA.

2.4. Physical Security Working Group

The EBF's Physical Security Working Group evaluated the trends of crime against banks in the EU based on an analysis of member state statistics on bank robberies in 2006. Statistics reveal that the number of bank robberies has decreased, although the reasons are varied. Banks' physical security standards have improved and, because of mergers and the increased use of electronic banking, the number of branches, as potential targets, has decreased. On the other hand, organised crime has shifted the focus onto white-collar crimes, given that card forgeries and internet frauds yield higher rewards and lower punishment.

The number of raids on cash transporters and ATMs continues to be high (and increasing in some member states). A priority in the working group's annual action plan was to identify how banks' internal security can prevent this type of crime. Another related point is how to identify those employees who may become blackmail targets due to addictions (alcoholism, drugs, gaming, etc.).

2.5 Social Affairs Committee (BCESA)

At its meetings in 2007, the Committee reviewed the status of the most important projects, including the demography project. A joint statement on demography is being drafted with UNI-Europa Finance, to be submitted to the European Council, other issues require further consultations (stress, school drop-outs). The EBF is in favour of a recommendation that does not impose barriers to taking into account national specifics.

Preparations commenced for the meeting of the enlargement project to be held in Budapest, organised jointly with the European Commission. The project is managed by the BCESA and it runs for one year.

Flexicurity is a key issue of the European labour market, which has various implications. The FBE set up a working group to assess these implications. The working group outlined the possible approaches. The Social Committee seeks a balanced use of quantitative and qualitative approaches.

2.6 Communications Committee

The Communications Committee continued to communicate issues affecting the industry, including MiFID, SEPA, the Political Statement on the Publication of the Final Report on the European Commission's Retail Banking Inquiry, the EBF's Report on the Integration of EU Financial Services Markets, etc.

Key issues addressed by the Communications Committee in 2007 included:

- Improving financial literacy,
- Corporate Social Responsibility,
- Ethical issue affecting the banking sector, international best practice.

At the end of 2007, the EBF's Executive Committee elected the Association's Chief Adviser, János Müller, as Chair of the EBF Communications Committee. This is recognition for the Association's work, as well.

2.7 Anti-Fraud and Anti-Money Laundering Committee

At the November meeting of the Committee it was raised that Regulation 1781/2006/EC on the transfer of funds (payer information) was not clear-cut enough and that additionally, new proposals have been made on this subject: the Wolfsberg Group proposed that MT202 SWIFT messages be complemented with three new fields for information on payers not acting in their own name. The EBF was opposed to this: the current regulation should be made unambiguous to ensure that the new provisions do not hinder or slow down payments. Experience shows that credit transfers with insufficient payer information typically arrive from non-EU banks.

V. OTHER ISSUES

1. Cooperation agreements

1.1. Sectoral Social Dialogue Committee set up

The Association concluded a cooperation agreement with the Union of Bank and Insurance Employees for setting up a **Sector Social Dialogue Committee** as a consultation forum to ensure continuous cooperation between the social partners; contribute to the creation and operation of an institutional framework for social dialogue in the financial sector; in cooperation with regulators, contribute to developing sector legislation in line with the Treaty of the European Union and the EU Constitution to be adopted, thus promoting legal convergence in Europe; within the constraints of law, contribute to developing missing professional standards and further developing existing standards, and participate in the development of related European standards; draft the Sector Social Dialogue Committee's Statutes, tasks, scope of authority and organisational and operational rules.

1.2 Cooperation agreement with the Budapest Police Headquarters

The Association concluded a cooperation agreement with the Budapest Police Headquarters, aimed at further improving personal and property security in bank's operations and customer service, preventing and efficiently responding to attacks on banks' IT systems and developing prevention procedures and measures aimed at preventing, detecting and intercepting criminal activities.

1.3. Foundation for promoting financial literacy

The MNB initiated the setting up of a **foundation for promoting financial literacy** and requested government agencies, professional associations and financial market participants to contribute funds, as founders or joining or supporting members, for the implementation of joint programmes.

The Association supports the idea and considers it important that the widest possible range of market participants (banks, insurance companies, financial enterprises, investment funds, Hungarian Financial Supervisory Authority, the National Deposit Insurance Fund, etc.) join. The funding requirements for the programme and the contributions expected from the foundation's members could be determined after defining the objectives.

The Association seeks to participate as a founder. Accordingly, we proposed that the Association's membership adopt a decision on the form and extent to which the Association should contribute to the operations of the proposed foundation.

2. Starting Block Programme

The Association held a Christmas Party for students and teachers of schools involved in the *Starting Block* Programme launched jointly with the “A Chance for Disadvantaged Children Foundation”. The Association funded the event. It is planned that this event in the future will be held not so much as Christmas party but as an annual reunion and experience exchange of students and teachers involved in the programme from Budapest and the provinces.

This is particularly needed for newly joining participants, who do not have practical experience in the programme and in related administration tasks, etc. Three secondary schools joined the programme with 3 students each in the school year 2007/2008:

- the Szilágyi Dániel General and Vocational Secondary School of Hajdúhadháza,
- the Arany János General and Economics Secondary and Healthcare Training School of Berettyóújfalu, and
- the Inczédy György Vocational Secondary and Training School of Nyíregyháza.

ANNEX

Board meeting agendas 2007

Date	Agenda
January 8, 2007	1. Briefing on proposed further reform measures in the areas of the pension system, health care system, higher education and the local government system. Presenter: Dr. Tibor Draskovics, Government Commissioner, State Reform Committee 2. Medium-Term Strategy of the Hungarian Banking Association (2007-2012) 3. Briefing on progress in the Starting Block Programme 4. Miscellaneous
February 14, 2007	1. Briefing on transposition of the new Capital Requirements Directive into Hungarian Legislation 2. Briefing on developments in legislation related to CRD transposition. 3. Proposal for amendments to lien provisions of the Bankruptcy Act. 4. Briefing on proposed amendments to the Association's membership fee rules. 5. Briefing on the Association's financial management in 2006 - preliminary figures. 6. Briefing on the management of the Association's securities portfolio. 7. Miscellaneous
March 19, 2007	1. Report on 2006 Activities of the Hungarian Banking Association (Document for the General Meeting) 2. Proposal for the 2007 Budget of the Hungarian Banking Association (Document for the General Meeting) 3. Proposal for amendments to the Association's Rules (Document for the General Meeting) 4. Briefing on expected Tax Authority inspections affecting the banking sector 5. Briefing on issues related to the management of the Association's securities portfolio. 6. Briefing on 2006 special bank tax payments 7. Miscellaneous
April 2, 2007	1. Proposal for setting up a Sector Social Dialogue Committee Guest: János Müller, President of the Union of Bank and Insurance Employees 2. Proposal for the setting up of the National SEPA Implementation Organisation 3. Proposal for the revision of the Association's Code of Ethics 4. Proposal for establishing a Commemorative Certificate and a Commemorative Coin 5. Miscellaneous

May 7, 2007	1. Briefing on main conclusions of the McKinsey study on competition in the Hungarian banking sector 2. Report on activities of the working groups set up based on recommendations of the Várhegyi Committee 3. Contract to be concluded with the McKinsey & Company consulting firm 4. Proposal for re-election of arbitrators of the Financial and Capital Market Court of Arbitration 5. Submission related to the issue of local trade tax deductible from corporate tax 6. Proposal for the admission of Bank Plus Bank and FHB Commercial Bank to the Hungarian Banking Association 7. Miscellaneous
June 4, 2007.	1. Economic development proposal Presenter: Géza Egyed, State Secretary 2. Concept for the communication of proposals for the development of the retail banking market 3. Proposal for asset management rules 4. Financial management of the Hungarian Banking Association in Q1 2007 5. Miscellaneous
September 3, 2007	1. Briefing on Association tasks ensuing from the document on measures aimed at improving the quality of retail banking services 2. Briefing on a request from the Data Protection Ombudsman concerning the SWIFT issue 3. Report on 2nd quarter activities of the Hungarian Banking Association 4. Financial management of the Hungarian Banking Association in the first half of 2007 5. Work programme for the second half of 2007 6. Miscellaneous
November 12, 2007.	1. Background document for the November 21 press meeting. 2. Report on main changes in tax laws affecting the banking sector in 2008 3. Report on developing the methodology and technical facilities for the HunOR Hungarian Operational Risk Database 4. Briefing on an MP motion for amendments to laws related to banking services, aimed at improving consumer protection, and on the Association's response. 5. Submission regarding issues related to the withdrawal from circulation of 1 and 2-forint coins 6. Briefing on the setting up of the National SEPA Implementation Committee and on the commencement of work related to the National SEPA Implementation Plan 7. Briefing on the financial management of the Hungarian Banking Association in Q1-Q3 2007. 8. Miscellaneous

December 3, 2007	1. Report on 3rd quarter activities of the Hungarian Banking Association 2. Proposal for cooperation with the Budapest Police Headquarters 3. Proposal for setting up the Sector Social Dialogue Committee 4. Miscellaneous