



HUNGARIAN BANKING ASSOCIATION

*Agenda item 2/a for
the General Meeting of April 23, 2004*

REPORT

ON 2003 ACTIVITIES OF THE HUNGARIAN BANKING ASSOCIATION

BUDAPEST, MARCH 2004

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I. ASSOCIATION LIFE, EVENTS

1. Extraordinary General Meeting

An Extraordinary General Meeting of the Hungarian Banking Association was convened on January 30, 2003, with two items on the agenda: amending the Association's Rules and modifying the Association's participation in the Money and Capital Market Arbitration Court and setting up a Credit Institutions Chamber within the Court.

The relevant proposals were duly adopted; all arbitrators got the required number of votes. Their term will expire on June 30, 2007, except for those arbitrators, who simultaneously are members of the Board of the Court: their mandate will expire on June 30, 2008.

2. Seminars

2.1 EU Directives on retail lending and the taxation of savings

A seminar addressing EU Directive on retail lending and its potential impacts on banks' operations in Hungary, and issues related to the EU taxation package (that is, ending the tax exemption on savings) was jointly held by the Association and the White & Case International Law Office on March 25, 2003. Presentations were offered by Jacquelyn MacLennan and Thomas Tindemanns from White & Case's Brussels office. The seminar was attended by legal counsels, compliance officers as well as sales, risk management and product development professionals from the banks.

The Draft Directive on the taxation of savings is expected to be enacted as of the beginning of 2005. The objective of the Directive is to prevent tax dodging through deposit placements abroad and to avoid double taxation in respect of the country where the interest is actually taxed. The Directive will apply to cross-border interest payments, without affecting, however, the regulations on taxation of interest revenues in the individual member states. Most member states will use the method of mutual information. Hungary will also apply this method after accession.

The Draft Directive on retail lending will be adopted at the end of 2004 at the earliest. The objectives of this Directive are to regulate cross-border lending, prevent excessive customer indebtedness and create a uniform regulatory environment and standard requirements in all member states. Corporate and mortgage lending will not be affected by the Directive. The Directive proposes that creditors set up common databases on debtors in default; these databases should be used by creditors on a mandatory basis prior to making credit decisions. The Directive also allows for setting up databases that contain positive data as well, including data on the client's existing loan contracts. The Directive addresses issues related to loan mediators, agents, their registration, supervision and the conditions of concluding loan contracts. It will allow an early repayment of the loan under a fair and equitable compensation. The Directive contains detailed provisions in respect of APR, unfair contractual conditions and prohibited methods for collecting overdue debts.

2.2 Transformation of subsidiaries into branches

A seminar on transformation of subsidiaries into branches and on the relevant taxation and legal framework was held jointly by the Association and Récicza Law Office, the Hungarian cooperating partner of the White Case International Law Office, on October 30, 2003.

Act CXXXI of 1997 on Branches and Trade Representations of Foreign-Based Companies in Hungary and the relevant provisions of the Credit Institutions Act did not provide any preferences for branching. The licensing process, capital requirements and operating procedures for branches were the same as those for subsidiaries, but the asset maintenance ratio requirement for branches limited credit institutions operating as branches in their ability to assume commitments. Therefore, none of the credit institution chose this form of operation. Pursuant to the provisions of the Credit Institutions Act taking effect on Hungary's accession to the EU (provisions based on Directive 2000/12/EC), the founding and commencement of operations of branches of EU-based credit institutions in Hungary and the appointment of senior officers of such branches will not be subject to supervisory licensing and there will be no minimum capital (dotation capital) or asset maintenance ratio requirements, either. Lending limits will be determined in proportion to the regulatory capital of the parent company, and therefore, higher lending limits can be realised (the legal framework of this is not yet in place).

EU-based credit institutions will be allowed to provide cross-border services in Hungary and will not be required to join the National Deposit Insurance Fund if they are members of the deposit insurance fund specified in Directive 94/19/EEC. The Hungarian Financial Supervisory Authority's powers will be limited in respect of branches: prudential inspections will not be performed and the Supervisory Authority's inspection powers will be limited to consumer protection and liquidity. Prudential inspection will be the responsibility of the home country supervisory authority. Additional supervisory tasks will be performed by the Hungarian Financial Supervisory Authority in co-operation with the home country supervisory authority.

Branches will have several advantages compared to subsidiaries: they will be easier to set up, management will be more simple; there will be no tasks related to the operation of independent joint stock companies and no dotation capital requirements, consequently, higher commitments and lending limits can be realised (the legal framework of this is not in place yet).

Pursuant to the relevant legislation, these advantages, of course, will only be enjoyed by branches of EU-based credit institutions; tighter regulations will continue to apply to branches of credit institutions based in third countries.

Existing subsidiaries may not be directly transformed into branches and there will be no joint and several legal succession: the branch will have to be set up, the subsidiary wound up and existing contractual liabilities will have to be transferred by assignment to the branch under a license from the Hungarian Financial Supervisory Authority. Staff, IT and other systems, liabilities and other commitments will also have to be transferred.

In relation to taxation issues related to the transformation of credit institutions into branches, an analysis was presented on expected changes in business after accession to the EU. Multinational companies always want to achieve the best taxation conditions possible in the long-term; accordingly certain operations are transferred to other countries and regions. The presenter drew attention to the fact that the high rate of trade tax makes Hungary taxation-wise less attractive

(notwithstanding the recent reduction of corporate tax, due to the high trade tax the effective profit tax rate is still around 30%; trade tax revenues probably exceeded corporate tax revenues in 2003.).

These discrepancies between Hungarian and EU tax laws will have to be eliminated upon Hungary's accession to the EU, and preparations will have to be made for the direct application of the relevant community laws in Hungary.

2.3 Internet Banking seminar

The Association launched a series of lectures on Internet banking in Hungary. At the session held on October 16, presentations were offered on the role of the Internet, Internet using habits in Hungary and the market-shaping impacts of Internet banks. In the introductory lecture, questions such as how and by whom the Internet is used in Hungary and Hungary's place in Internet use in international terms were reviewed.

Kálmán Kovács, Minister of Informatics and Communications gave an overview of the Government's IT vision and strategy on Hungary's current Internet coverage. He emphasised that 2003 was a turning point: up to 2002 Hungary ranked among the last in the OECD's survey on Internet use; then, in 2003 there was a significant increase above the EU average in the number of broadband Internet users, partly due to the Government's objective to promote Internet use at large under its Europe Plan by supporting PC purchases, cutting Internet charges by 25% and promoting the development of broadband Internet networks through tax allowances.

The promotion of electronic signatures, smart cards and security enhancements is particularly important for the banking sector, as these are tools that can create the conditions for cooperation between public administration and the banking sector. The government's long-term plans include the creation of one-stop electronic services for affair handling and for managing payments with central government agencies through the Government Portal. For this, a cooperation framework with banks should be established. In this context, a lecture on internet-based administrative and public services was offered by the Head of the Government Portal Division to present how the "provider state" can meet the challenges of our times through the Internet. The Government Portal enables government agencies to maintain regular communications with citizens and other organisations. Developing the e-Government Strategy and Programme Plan for 2005 is a key task for the coming period. In this, the Comprehensive EU Integration Programme will play an outstandingly important role.

Lectures were offered on the development of Internet Banking, including the history of Internet banking services in Hungary, evolution of the number of customers, potential target groups, needs and requirements of old versus new customers, Internet banking habits and customer aspects taken into account in the banks' development plans. Issues related to the market-shaping impacts of Internet banking, current problems and teething troubles and technological development prospects were also reviewed. Current and future trends as well as prerequisites for the large scale use of Internet banking, including potential growth areas and the relevant development strategies were also addressed. Banking professionals presented their own experience, problems and development ideas. It was proposed that banks, as a community, should coordinate their strategies in order to be able to respond to the government's requirements and the ensuing tasks.

The second session of this seminar was held on November 11, 2003. Presentations were offered on legal issues related to e-commerce (including law harmonisation with regard to Hungary's accession to the EU), issues related to the development of national IT security and certification schemes, electronic banking services, EU law harmonisation, e-Government, data protection over the Internet, handling and protection of personal data, electronic administration, technical and business opportunities offered by the Internet in banking, future prospects, risks related to client identification, and changes in Internet using habits in Hungary.

2.4 ISDA seminar

A one-day seminar on the role of derivatives in the money markets was held by the Association on June 2, in cooperation with the ISDA (The International Swaps and Derivatives Association) and the London Office of TAIEX (Technical Assistance Information Exchange Office).

The seminar was attended by professionals from banks, the Ministry of Finance, the Hungarian Financial Supervisory Authority, the Government Debt Management Agency and PriceWaterhouseCoopers (about 50 people in total).

In his presentation, dr. David Mengle, head of ISDA's research unit, Guest Professor at Fordham University, reviewed the role of derivatives and their areas of use, risk management and the various types of swap transactions, pricing, yield curves, the zero coupon yield curve, the computation of forward yields, the pricing and valuation of option deals and the most frequently used pricing models.

Professor Mengle also gave a review of the various areas of use of derivatives. The use of derivative instruments for interest and credit risk hedging and the expected results were presented through practical examples.

Dr. Zoltán Lengyel from Allen & Overy reviewed legal issues arising from Hungary's accession to the EU and hedging transactions and their application in the Hungarian legal environment. The relevant EU Directive (2002/47/EC) and ISDA hedging sample agreements were presented.

The session was concluded by a presentation by Dr Júlia Király and Zoltán Kurali on the evolution of the HUF derivatives market, forex and interest rate swaps, foreign exchange option and forward markets, and the use of derivative products in the corporate and retail sectors and among importers and exporters. Main challenges for the banking sector in connection with Hungary's joining the EMU were also addressed.

2.5 Wealth Management seminar

ATTF Luxemburg held its Wealth Management Seminar for Central and Eastern European bankers (supported by the Luxemburg Ministry of Finance) between November 3 and 12 in Budapest. The Association assisted in organising the seminar.

3. Consultations

3.1 Consultation on land registers

The Administrative State Secretary of the Ministry of Agriculture in the fall of 2002 requested the Association to organise a consultation on current issues related to land registration, including a faster registration of mortgages, the TAKARNET system /a cartography-based cadastral system, providing access to the data of land offices nationwide/ and other issues raised by banks. Banks' comments were summarised and sent to the Ministry and copied to the commenting banks. A consultation on the subject was held on March 26, 2003 (the Ministry could not fit the consultation in its schedule earlier due to other engagements). The meeting was attended by the Land and Cartography Department, the Institute of Geodesy, Cartography and Remote Sensing of the Ministry of Agriculture (FÖMI), legal counsels and risk management and collateral rating specialists from banks. The TAKARNET system was presented by the Geodesy Institute.

Participants were briefed on the services of the Geodesy Institute, the conditions for linking up to the TAKARNET system and the related service charges. All title page data are now on computers at the land offices and are available for outside users (local governments, Courts, Notaries Public, lawyers, banks, etc.) through the TAKARNET system.

3.2 German bankers' delegation

Arranged by Hypothekbank, Essen, a delegation of 31 bankers from Germany visited the Association on October 3. The purpose of the visit was to acquire information on capital investment opportunities in Hungary. The Association's Secretary-General gave an overview of Hungary's economy and growth prospects. Questions were asked about consistency between monetary and fiscal policies and about Hungary's inflation outlooks.

3.3 Visit of members of the Financial Committee of the Italian Parliament

A delegation of the Italian Parliament's Financial Committee arrived in Budapest within the framework of a series of visits to accession countries. During its visit the delegation had talks with the Ministry of Finance, the Hungarian Financial Supervisory Authority, the State Audit Office, the National Bank of Hungary. The delegation also had a meeting with the Hungarian Banking Association. The state of the Hungarian economy and current issues related to the financial system were reviewed, with special regard to the stability of the financial system and the forthcoming privatisation of banks yet in state ownership.

3.4 Consultation with the SWIFT User Group

Banks requested the Association to organise a consultation to prepare the election meeting of the Hungarian SWIFT User Group.

This organisation had been headed for many years, by a reputable person of the profession, without any special formal framework, whose sudden death left the organisation without guidance and management. Members of the group turning to the Association sought to have an informal consultation to clarify the operational framework of the organisation: the rights and

obligations of leaders and members of the organisation, its financing, and the rules for electing the head of the organisation (and possibly, his or her deputies).

At the consultation, arranged by the Association and attended with keen interest, all issues raised were reviewed. Consensus was reached on number of issues (including financing), other questions remained to be settled by formal meetings of the User Group.

4. Forums, working groups

4.1 Basel II – CAD 3 Working Group

In connection with the proposed reform of the Basel Capital Accord, an ad hoc working group was set up in May to develop a common position on behalf of the Hungarian banking community on the Third Consultative Paper of the Basel Committee (CP3) and the new EU Capital Adequacy Directive (CAD 3). After a review with our member banks, our response to the Third Consultative Paper was sent to the Hungarian Financial Supervisory Authority, the body responsible for developing the Hungarian position in the consultative process. Comments on the proposed new capital adequacy directives were sent to the competent working group of the FBE.

4.2 Research project on the bank and credit card markets

The organisers of an American-Hungarian joint research project on the credit card market requested the Association to arrange for an opportunity to present their research plans to domestic bank card market players.

The event was the first to be jointly organised by the Hungarian Banking Association and the Bank Card Forum. The opening presentation gave an overview of the credit card market. Researchers explained that their work was basically focused on countries where credit cards were introduced only a few years ago; they would like to treat separately the more advanced countries (such as Hungary and Poland), those in the early stages of transition (Bulgaria, Ukraine) and the quasi-market economies, functioning within socialist settings (Vietnam, China). The research is aimed at the process of shifting from a confidence-based lending, built on individual customer relations, to a statistical probability-based credit card market, using the most modern IT infrastructures. The topic was received with keen interest, as shown by the Q&A session following the presentation.

Issues related to the standardisation of bankcards were also reviewed. First, the colleagues representing the Association in the ECBS gave a presentation about the ECBS and its activities, with special regard to the work of the Bank Cards Sub-Committee. Then, colleague from the National Bank of Hungary, representing the banking profession on the Hungarian Standardisation Board, reviewed standards related to the profession.

4.3 Bank Card forum

The Bank Card Forum held its next scheduled meeting on October 20, 2003, with the participation of 26 professionals from member banks.

Dr István Varga, Head of the Consumer Protection Department of the Hungarian Financial Supervisory Authority, reviewed the regulations affecting the financial sector in connection with Hungary's accession to the EU. Bankcard and consumer protection regulations and the relevant

EU institutional systems were addressed in details. Other items covered included consumer protection strategies applied by the EU and those followed by the Hungarian Financial Supervisory Authority; the need for a standard legal framework, FIN-NET (a forum for settling cross-border financial disputes) and the plan of establishing a common telephone line for bank card cancellation. Issues related to interconnecting debtor databases were also addressed.

István Prágay, Head of the Payments, Emission Regulation and Organisation Department of the National Bank of Hungary (MNB), gave an overview of the adoption of EU financial recommendations, guidelines and directives, emphasising that effective from May 2004, EU financial regulations will be automatically adopted in the relevant Hungarian legislation. He also gave a detailed presentation about the 8 recommendations drafted by the European Payment Council with a view to developing a Single Payment Area.

The Council has the following main objectives:

- protection against fraud,
- open competition in promoting the use of bank cards in the European market,
- coherent regulation,
- promoting the standardisation of authorisation, clearing and terminal specifications.

4.4 Meeting of the TC1 Committee

At the invitation of the Hungarian Banking Association, the ECBS Payment Cards Technical Committee held its meeting in Budapest. The meeting addressed technical issues related to bank cards.

4.5 Payment System Forum

At the initiative of the National Bank of Hungary, a Payment Systems Forum was set up on June 11 with the participation of the National Bank of Hungary, the Hungarian Banking Association, the top ten banks in terms of payment turnover and the Hungarian State Treasury. The objective of the Forum is to promote the development of the payments and settlements system, with special regard to the challenges posed by Hungary's accession to the EU. By setting up the Forum, the National Bank of Hungary, as the organisation responsible for ensuring the efficient operation of the payments and settlements system has created an institutional framework for reviewing the most important strategic issues affecting the entire community of players in the payments and settlements system and for preparing professional proposals. Savings co-operatives will engage in the work through the National Interest Representation Association of Savings Co-Operatives (TÉSZ) and the National Federation of Savings Co-Operatives (OTSZ). The Forum is of consultative nature; it formulates recommendations, developed based on a consensus of the professional community, aimed at providing best practices in specific issues related to the payments and settlements system. Recommendations are not compulsory but can be implemented in practice and incorporated in future regulations.

The Forum's organisation has three levels. Its supreme body is the Payments System Council, which has 15 members and meets twice a year. The institutional and personal composition of the Council was determined by the founding meeting. The second level consists of professional committees. The third level comprises working groups, whose task is to develop specific projects for resolving issues adopted by the Council.

Activities of the Council are assisted by a secretariat staffed by the National Bank of Hungary. Activities of the Forum are supported by a coordination group made up of the professional associations involved (the Hungarian Banking Association, TЭСZ and OTSZ).

Basically, the organisational structure of the Payment System Forum is similar to that of the European Payment Council (EPC).

Three out of the six technical committees of the Forum held their founding meetings in the fourth quarter of 2003.

- The Technical Committee for the Development of Cashless Payment Methods set up three working groups: the Direct Debit group, responsible for further developing and publicising multiple collections (introduced in 1997), and the List Payments and OCR (Optical Character Reader) working groups, tasked to develop these two new methods of payment.
- the Technical Committee for Cash Transport and Processing also identified the main areas where working groups should be set up.
- The Cards Technical Committee has one working group, to prepare the chip migration of magnetic cards.

The Technical Committees for VIBER/RTGS (Real-time Gross Settlement System), KELER (Central Clearing House and Depository), GIRO Ltd. and the Standardisation Technical Committee are expected to be set up in early 2004.

A Coordination Group made up of the Hungarian Banking Association, the National Interest-Representation Association of Savings Co-Operatives (TЭСZ) and the National Federation of Savings Co-Operative (OTSZ) is expected to submit the documents to be compiled by the working groups for review by credit institutions and savings co-operative in March 2004. The Association will be represented by two colleagues at the meetings of the technical committees and working groups.

At the request of Inter-Europa Bank, supported by eight other banks, we initiated that the Technical Committee for the Development of Cashless Payment Methods set up a working group to address liability issues in electronic banking and adoption of the relevant EU rules and guidelines in the Hungarian legislation. The working group is expected to be set up in the first half of 2004.

4.6 Inter-Ministerial Coordination Committee on Information Society

The Hungarian banking community has given special emphasis to developing electronic banking services in recent years. The Hungarian Banking Association finds it important for the Hungarian banking community to actively participate in the work of the Inter-Ministerial Coordination Committee on Information Society, set up based on Government Decree No. 1214/2002 (XII 28).

Pursuant to the above mentioned Government Decree, this Coordination Committee participates in the development and implementation of a uniform government strategy and action plans in relation to information society. It monitors the management of domestic and international

supports, programmes and application schemes, promotes the development of Hungarian information technology and communications standards and coordinates technology enhancements required for IT security and the EU integration sector policies of Ministries in relation to information society. The Committee coordinates the development of implementation concepts for non-governmental information technology and communications networks financed from the central budget and the implementation of the relevant investment projects; it participates in the preliminary assessment, study and analysis of impacts of development projects aimed at promoting the development of information society and encourages, coordinates and reviews the development and implementation of information society sample projects.

Involved in the Coordination Committee's activities are government agencies, the national institutions affected, and economic and business players, represented through their professional organisations. An immediate task for the Committee is to develop, based on the various sub-strategies, a comprehensive Hungarian Information Society Strategy to serve as a basis for actions between 2004 and 2006.

Additional tasks to be completed parallel with drafting the strategy:

- developing a sub-strategy and an operative action plan for promoting and broadening the use of electronic signatures,
- developing an authentic quality and security certification systems for IT applications,
- developing programmes and a medium-term plan for eliminating the digital gap and to promote the catching up of strata of society falling behind or being at a disadvantage in relation to information society.

As a member of the Coordination Committee, the Hungarian Banking Association has been represented on the Committee by its Secretary General since October 2003. The Association also represents itself on the IT Security Sub-Committee. The task of this Sub-Committee is to promote, through inter-ministerial coordination, the creation of legal and organisational frameworks and technical conditions for IT security.

5. Study discussions

5.1 Study titled "The Almost Operating Market"

The discussion of this study, prepared under the coordination of the International Training Center for Bankers, was attended by representatives of the National Bank of Hungary, the Budapest University of Economics, the International Training Center for Bankers, the Stock and Commodity Exchanges and investment funds.

In his brief introduction, the Association's Secretary General commended for the high professional standards of the study, a thought-provoking work that helps recognise market development potentials from the perspective of risk management and better understand the magnitude of the exposures assumed and their coverage; certain concrete initiatives can also be built on the conclusions of the study (e.g., IAS 39).

The authors presented the objective and structure of the study, emphasising their efforts to use a standard terminology and to provide an analysis of the development and prospects of derivatives market by customer segment and market player. The authors pointed out that derivatives can be used not only for covering risks but also for generating additional income and are therefore

expected to have a pull on the capital market. Accounting and financial regulations are prerequisites but not sufficient conditions for the wide-spread use of derivatives. It will take companies a paradigm change. Companies are not adequately informed; exporters in many cases think in terms of expected exchange rate changes rather than using derivatives products.

5.2 Study titled "Competition and Profitability in the Banking Sector"

This study was written by Éva Várhegyi, on assignment by the Competition Authority. The Competition Authority asked the Association to arrange for a discussion of the study. The discussion was attended by representatives from the Competition Authority, the Hungarian Financial Supervisory Authority, the International Training Center for Bankers, the Hungarian Banking Association and member banks.

In her brief introduction Éva Várhegyi presented the study, whose objective was to assess the current situation in the Hungarian banking market, the specific features of competition in the banking sector, and to establish whether or not the welfare impacts in this sector are different from other sectors.

To answer these questions, the author looked into the correlation between competition and market stability, the applicability of the various and generally known models and international examples. A conclusion was that concentration in the Hungarian banking market - and particularly in the retail market - slowed down in the nineties.

Restructuring in the banking market created the conditions for the evolution of competition and vulnerability. The study showed an apparent interest rate flexibility in the market, indicating that competition in the corporate banking sector is satisfactory; in other words, banks are forced to adjust their interest rates to their marginal costs and returns; in the retail market, interest rates are not so much correlated with changes in the money market and therefore, in the current market structure banks can still realise monopolistic gains.

Pricing behaviour largely impacts the profitability of banks. Interest margins and operating costs are double those in the EU. The share of interest income is 50% in the EU and around 70% in Hungary.

Participants complemented the conclusions of the study with their own experiences. The representative present from the Supervisory Authority noted that variety, quality and prices play a major role in the benefits of competition in the banking market from the point of view of the consumer; impact on competition should be a criterion during bank privatisations.

The representative from the Competition Authority noted that based on the complaints they have been receiving it appears that price increases in Hungary are not always associated with an improvement in service standards; banks' information discipline is not satisfactory, customers are defenceless against misinformation.

6. Ethics Committee

The number of cases referred to the Ethics Committee in 2003 was substantially less than in the immediate period following the setting up of the Committee. This was attributable to the following main reasons:

Firstly, and perhaps, most importantly: the adoption of a Code of Ethics was a right and successful decision by the Association; the principles and procedures laid down therein have been accessible, clear and generally acceptable by all parties involved. Accordingly, the general observation is that the overwhelming majority of the parties subject to the Code do refrain from any ethical misconduct. Nevertheless, after a five-year experience, it might be worthwhile to review the Code for any possible amendment that might be needed.

Another main reason was the Ethics Committee's approach of trying to settle disputes peacefully to avoid any ethical procedures or litigation. During such disputes, members of the Committee attempted, often through personal interventions, to mediate and to seek mutually acceptable solutions for the parties involved. The Committee's mediation efforts have proved efficient and successful.

The third reason for the decrease in the number of ethical cases was the new provision of the Ethical Code, according to which the Ethics Committee no longer has the power to directly institute ethical procedures: ethical procedures are now instituted if so requested by any member of the Hungarian Banking Association or by any customer of a member of the Association or at such initiative by the Association's Board.

Finally, it should also be mentioned as a reason that customers are less inclined to initiate ethical procedures and tend to seek other forums for settling their complaints. This may be due to the fact that customers prefer other types of procedures, which involve more efficient sanctions: an ethical censure is not good enough for those who feel their interests have been prejudiced by a bank's misconduct.

Three cases were filed with the Ethics Committee in 2003. In two of them, ethical procedures were unwarranted. The third case was taken up by the Committee, but the procedure had to be suspended until other procedures, instituted in parallel (with the Hungarian Financial Supervisory Authority, the Tax Office, etc.), are concluded, given that the documents available did not provide conclusive evidence for an ethical misconduct that could offer general conclusions.

II. PROFESSIONAL ACTIVITIES

The Association's activities in 2003 continued to be focused on the review of draft laws and regulations affecting the banking sector.

1. Regulations affecting credit institutions' operations

1.1 Act on Credit Institutions and Financial Enterprises

The draft law on amendment to Act CXII of 1996 on Credit Institution and Financial Enterprises (Credit Institutions Act) was presented to Parliament in March 2003.

The proposed amendments are primarily required for harmonising Hungarian laws with the relevant EU legislation and address two main issues:

- Re-regulation of consolidated supervision of credit institutions,
- Adoption of the provisions of Directive 2001/24/EC of the European Parliament and the Council on the reorganisation and winding up of credit institutions.

Consolidated supervision was connected to a simultaneous amendment to the Capital Market Act.

The objective of the regulation on the consolidated supervision of companies associated through ownership or other control relations is to ensure a transparent risk management and to prevent the "concealing" of risk exposures from the Supervisory Authority. Subject to consolidated supervision are credit institutions that hold a participation in a credit institution or a financial enterprise or are a parent company of such institution or whose parent company is a financial holding company. **The Supervisory Authority may primarily take action against the credit institution that is subject to consolidated supervision.**

Credit institutions and financial holding companies subject to consolidated supervision are responsible for the prudent operation of the group on a consolidated basis. This means that **the limits for large exposure must be complied with also on a consolidated basis and the consolidated solvency ratio may not be less than 8%.**

In line with European Parliament and Council Directive No. 2001/24/EC, the **amendment to the regulations on the winding up of credit institutions** will strengthen client protection in cases where the winding up of a credit institution affects clients in other member states (foreign branches, cross-border services). Court decisions on winding up or final accounting will be effective across the entire territory of the EU. Bankruptcy, winding up or final accounting procedures instituted against an EU-based credit institution will be governed by the legislation of the home country. The relevant court decision shall be published in the Companies Gazette and the official gazette of the European Communities and in two national daily newspapers of the member state where the branch operates or where the cross-border services have been provided.

Adoption of the relevant EU legislation required amendments to the regulations on the foundation of companies. In the future, the supervisory authority will have to reject the

application for foundation if the owners fall under the jurisdiction of such a third country, where supervision cannot be adequately performed.

The new law amended the Acts on mortgage institutions, building societies and co-operatives, to prevent investment co-operatives from gathering investors through public calls or advertisements with promises for extraordinary returns.

Most of the proposals submitted by the Association were not adopted by the Ministry on the grounds that the law amendment were confined to those most urgent issues that are directly related to law harmonisation. In a letter to the Finance Minister we requested that amendments not enacted this time be incorporated in the legislation prior to accession to the EU.

1.2 Capital Market Act

A draft amendment to Act CXX of 2001 on Capital Market, also required for harmonising the laws with the relevant EU legislation, was presented by the Ministry of Finance simultaneously with the draft amendment for the Credit Institutions Act in March. The proposed amendment provides new regulations on capital adequacy requirements and complements the regulations on supervision with provisions on consolidated supervision.

Another main subject of the draft law is the provision of requirements for fund managers of European investment funds. Fund managers managing European investment funds will have a Single European Passport after accession. Current fund managers who wish to manage or set up European investment fund will also have to meet these requirements.

The new legislation provides for rules for reporting and provision of information on cross-border services. Also, the rules for portfolio management and securities lending were fine-tuned.

The Association submitted several wording/interpreting proposals for the text of the draft law.

1.3 Draft law on amendments to certain laws aimed at increased investor and depositor protection

The draft law contained amendments to the following laws:

- Act CXII of 1996 on Credit Institutions and Financial Enterprises
- Act CXX of 2001 on Capital Market,
- Act CXXIV of 1999 on the Hungarian Financial Supervisory Authority
- Act XV of 2003 on the Prevention and Impeding of Money Laundering
- Act XLI of 1991 on Notaries Public
- Act on Co-Operatives

The President of the Republic did not sign the Act but sent it to the Constitutional Court for constitutional review. Accordingly, the Act has not been promulgated and therefore, cannot be applied.

1.4 Regulation on payments

After repeated requests, the National Bank of Hungary (MNB) invited a consultation on the proposed regulation on payments prior to the official inter-ministerial review. As a result of this consultation

- the regulations on bank cards have improved from the point of view of banks: the customer's duties have been specified more lucidly.
- the category of customs accounts and provisions on their use were added to the draft,
- MNB insisted on the content requirements for bank statements (which we had challenged as being too detailed) but the introduction of these requirements was postponed by the beginning of 2004.
- banks have been allowed to terminate account contracts with undesirable customers during queuing (with the proviso that the items already accepted shall be managed as required),
- banks' tasks related to account identification have been specified in a more clear-cut manner (the cases of identification by account and by account and name, respectively),
- adequate time was given for preparations.

1.5 Customs accounts

The Customs Authority (VPOP) requested the Association to join the working group set up to develop a customs account pursuant to a 2002 amendment to the Customs Act, aimed at improving the collection of duties through a special bank account subject to the Customs Authority's exclusive right of disposal.

Responding to the request, the Association organised three meetings for the working group. A number of issues were raised by banks concerning the proposal.

In relation to the proposed amendments to payment regulations then in progress we took up the matter with National Bank of Hungary to ensure that the provisions on customs account are incorporated in the proposed regulation in such a manner that they do not prejudice the Customs Authority's exclusive disposal right. Also, we developed a proposal to resolve the problems arising from a direct intervention by the Customs Authority into the banks' IT systems.

1.6 Data protection

Based on banks' comments, the Association compiled a document in connection with the amendment to Act No. LXIII of 1992 on Protection of Personal Data, taking effect as of January 2004, and the interpretation of Act LXVIII of 2003. Jointly with the National Federation of Savings Co-Operatives (OTSZ), the Association of Fund Management Companies in Hungary (BAMOSZ) and the National Association of Securities Dealers (BSZSZ), a request was filed with the Ministry of Finance and the Data Protection Ombudsman, seeking their opinion and ruling on the issues raised.

A number of interpretation issues were raised, inter alia, in relation to the ombudsman's right of preliminary review, the appointment of internal data protection officers at financial organisations, data protection and data security manuals, the definition of database, connecting various forms of data processing, automated individual decisions, transfer of data to third countries and powers of the Data Protection Ombudsman. We pointed out that Hungarian data protection laws are in a number of issues much tighter than the relevant EC Directive (Directive No. 95/46/EC) and therefore, more difficult to implement.

The Ombudsman said there were no more amendments to the Data Protection Act expected in the near future or during this election cycle. Also, he was most strongly opposed to the proposed positive list database and expressed his objections to the proposal to set up a voluntary database.

Effective from the beginning of 2004, all financial institutions falling within the scope of the Hungarian Financial Supervisory Authority are required to appoint an internal data protection officer and to draw up an internal data protection manual. As for the form of employment of data protection officers, flexible solutions are acceptable (part-time, assignment contract, etc.). In respect of the definition of database, all data stored in a financial institution's database are to be treated as a single database. According to the provisions of the law, data processing may not be assigned to businesses which, in any form, are interested in the financial organisation's activities (meaning: competitors). Customers are to be notified on automated individual decisions; for this purpose, a summary information suffices. As for transfer of data to third countries, two relevant EU Directives may be applied already before May 1, 2004. The Ombudsman proposed further discussions concerning the blacklisting provision of the Credit Institutions Act.

The Ombudsman proposed further discussions concerning the blacklisting provisions of the Credit Institutions Act. The Data Protection Ombudsman found the data management of financial organisations (and primarily, banks) acceptable and offered the possibility of regular consultations.

The Ombudsman's written answers to our questions were forwarded to banks for their reference and sent to the Ministry of Finance, the Hungarian Financial Supervisory Authority and Interbank Informatics Service Ltd. (BISZ Rt.) for their information. In relation to the interpretation of subsection 53 (3) on data provision in the Credit Institutions Act the Ombudsman said that data may be forwarded to the BAR system also in cases where a debt with an amount less than the minimum wage reaches the minimum wage beyond 90 days. In this case, both criteria would be present. The Ombudsman's ruling confirms the position taken earlier by the banks.

1.7 Proposed inter-bank private debtor and credit information system

At its meeting of June 10, 2003, the Association's Board adopted a decision to investigate the possibility of setting up a voluntary inter-bank debtor database (ÖLBAR). A working committee was set up to address practical and legal issues related to the operation of the proposed system. The Committee consists of professionals from the National Bank of Hungary, Interbank Informatics Service Ltd. (BISZ Rt.) and Giro Ltd., the Association and member banks. The operational concept of the system was drawn up.

Under this concept, through a single query, users would have access to negative data, legally provided by other users, as well as to positive data. Users not joining the system would only have access to negative data.

The participants pointed out that for the system to be viable, banks representing the dominant part of the lending market (80-90%) should join, the issue of system administration should be resolved, issues related to customer approval should be addressed and agreed upon in details, and the opinion of the Data Protection Ombudsman should be obtained.

Based on the banks' answers it was established that the desired 80% coverage could not be achieved through a voluntary system. Reviewing the issue at its meeting of September 8, 2003, the Board concluded that the proposed inter-bank private debtors database could not be viably set up on a voluntary basis; accordingly, the initial concept of a mandatory debtor database should be re-visited and revised based on the opinion of the Data Protection Ombudsman and the relevant international practice. The proposal has been re-designed, with due consideration to the Ombudsman's recommendations made in the fall of 2002. Only those loans with amounts exceeding a certain lower limit would be registered and the concept of an initial upload would not be applied when designing the system. The system would be open to additional remedies over and above the current consumer protection and legal remedies. The proposal is currently under review.

A review of the proposal was completed in October 2003. Involved in the review were banks active in home lending, the National Bank of Hungary, GIRO Ltd. and Interbank Informatics Service Ltd. (BISZ Rt.). A copy of the proposal was sent to the Housing Policy Sub-Committee of Parliament in view of the fact that the Sub-Committee had some discussions with the Data Protection Ombudsman that affected, inter alia, the issue of debtor database.

The proposal was not submitted to a broader review (involving Ministries), given that Data Protection Ombudsman has publicly stated on several occasions that he disagreed to the proposal and would avail himself of the means at his disposal to prevent the implementation of the proposal.

1.8 VAT charged on credit rating

The problem of VAT charged on credit rating is not new and, as indicated by banks, has failed to be resolved in a satisfactory manner ever since the enactment of the new Credit Institutions Act in effect from January 1, 2003. Although the amended Schedule No. 2 to this Act clearly provides that lending activities include credit rating, yet, exemption from VAT is not always applied to credit rating. During lending, credit institutions must assess the customer's financial and income position and the availability, actual value and enforceability of the collateral required before approving the credit. For this activity, a credit rating fee is charged. Banks say according to some official standpoints credit rating is an independent service subject to 25% VAT. The matter was once again referred to the competent State Secretary at the Ministry of Finance, to clarify and resolve the issue. The Ministry did not accept our arguments, the regulation and its legal interpretation remained unchanged.

1.9 Reporting requirements of the Hungarian Financial Supervisory Authority

The Supervisory Authority (PSZÁF) advised as late as the end of January that reports to be submitted in January 2003 should already be provided according to the new formal requirements. Banks requested the Association's urgent intervention in view of the fact that:

- the required IT developments could not be implemented within the short time allowed,
- no practical help had been provided by the Supervisory Authority regarding the changes required; the supervisory authority's checking program had not completed in time (this program must be run for all reports without any error before submission) and the Supervisory Authority had failed to provide for a testing period to test the changes.

The common central bank/supervisory authority report structure, compiled with a painstaking work, seemed to disintegrate, as the tables that until then had had the same contents would have been required to be submitted to the two authorities in different formats (with substantial costs and extra work).

The Association requested the Supervisory Authority to hold a consultation to review the issue with specialists from member banks. At the consultation, representatives of the Supervisory Authority explained the reasons for the changes. Banks submitted the main problems in implementing the new requirements and the position of the Association's Board was presented. Following the consultation, an auxiliary programme helping to bridge the formal differences between central bank and supervisory reports was prepared and made available to banks.

1.10 Measures for the prevention of terrorism and money laundering

Hungary was removed from the FATF list of countries to be monitored in the summer of 2003. However, to preserve our status, at least the current level should be maintained and the relevant provisions of Act XV of 2003 should be complied with.

A number of problems were encountered during the implementation of this Act. One of the problems was related to the implementation of **identification** requirement. The Act provided that no transaction may be performed for clients whose data specified by the law are not fully available after January 1, 2004. Banks conducted surveys from mid-2003 to determine the number of customers affected. The surveys showed that corporate customers of major banks are affected the most. Owners' and clients' authorised representatives' data were those typically missing. The Association's Anti-Terrorism and Money Laundering Committee proposed that the Hungarian Financial Supervisory Authority issue a standard Notice (to ensure level playing field) to be sent out by banks to their customers, attached to their bank account statements. The Supervisory Authority was highly cooperative and, after joint preparations with the Association, the text of the Notice was sent to the banks' for their reference. Since the deadline has since been extended to March 2004, the review of identification details will be completed in the first quarter of 2004.

Data requirements for **international transfers** are another key issue. In the mandatory Sample Procedures drafted by the Hungarian Financial Supervisory Authority, the law was interpreted in such a way that a transfer may not be executed or forwarded if any of the 3 data specified by the law are missing. Banks indicated that in 80% of the cases only two of the three required data are available and therefore this provision of the law cannot be implemented. With the active participation of member banks and through the Inter-Ministerial Committee, the Association furnished the Ministry of Finance and the Financial Supervisory Authority with extensive information proving that the relevant provisions of the law cannot be implemented. Based on this, a respective draft amendment to the Act was presented to Parliament in December 2003. (The problem was rooted in the fact that the FATF's requirements to be introduced from 2005 have been adopted in Hungary, but not so in other countries yet). Regretfully, the President of the Republic did not sign the Act but sent it to the Constitutional Court for constitutional review. As

a bridging solution, the government extended the deadline for client identification from December 31, 2003 to March 31, 2004 and allowed client identification to be performed through clients' representatives. Nevertheless, the law still failed to provide satisfactory solutions in respect of international transfers and reporting obligations of investment firms.

Meanwhile, through informal channels we learnt that the Government Decree that had been discussed for years and was aimed at regulating bank security on government level was reviewed by the government and was taken off the agenda on the grounds that the decree was not warranted and the matter should be managed by banks and their interest representation organisation.

The Association's Anti-Money Laundering Working Committee initiated a coordination of language and timing of the client identification notice to be issued to the public, to avoid any "competitive disadvantage" for any of the banks and to make customers aware that those are not the banks' own initiatives but a legal requirement.

The Committee proposed that - similarly to previous initiatives of the Supervisory Authority (complaints, insurance issues) - customers to be mailed a Supervisory Authority circular enclosed with their September bank account statements.

1.11 Amendment to Government Decree No. 12/2001 (I. 31.) on housing support granted by the state

An urgent meeting was summoned by the Ministry of Finance on December 10, 2003 in connection with the proposed amendment to the government's housing support scheme. The proposal contained a significant cut of existing preferences, with immediate effect. The loan amount and the rate of preferences for loans granted against mortgage bonds were amended: preferences for the purchase, enlargement or renovation of second-hand apartments may not exceed HUF 5 million per apartment (for new apartments, the preference is invariably HUF 15 million). Interest and fees charged during the loan period may not exceed 110% of the government bond yield plus 4 percentage points, minus the interest subsidy specified in Subsection 12 (3) of the decree. The rate of interest subsidies is 60% of the government bond yield for the construction or purchase of new apartments and 40% for second-hand apartments. The government bond yield is the previous three months' average published by the Government Debt Management Agency.

Banks attending the meeting submitted several observations to make the decree more specific and to facilitate implementation. Many opined that after so many, often ill-prepared, amendments, the result is now a controversial and confused regulation that is most difficult to implement. Some suggested that the decree should be entirely reviewed and revised.

2. Regulations affecting banking operations

2.1 Computation rules for local taxes

The Association turned in a letter to the Minister of Finance, given that the November amendment to that Act on Local Taxes contained a change prejudicial to banks, effective from January 2004. If literally interpreted, this change means double taxation, certainly not intended so by the regulator. We requested the Finance Ministry's ruling on the issue.

We expressed our general objection to the discriminative provisions on determining the tax base for credit institutions and investment firms, namely: for certain activities, expenses may not be deducted from revenues when determining the tax base. We submitted a motion to the Constitutional Court in this matter and turned to the Minister of Finance in order to find an urgent solution to the problem. The Ministry of Finance was receptive to resolving the issue.

2.2 Use of bank cards for preferential public healthcare services

The Head of the National Health Insurance Fund (OEP) requested a meeting with the Association to discuss the possible ways to use bank cards/electronic purses to finance public healthcare services.

At the meeting, the Head of OEP explained that in view of the substantial damages caused by frauds, the OEP is, under a separate law, required to modernise and strengthen the control of instruments used for financing preferential public healthcare services. The OEP expects that the use of bankcards will help keep subsidies per patient under control. The OEP said they did not want to issue chip cards, bankcards would suit the purpose.

The issue was reviewed at a discussion held with banks involved in bankcard operations. According to the proposal developed at the meeting, magnetic cards would be used; these would be distributed by the municipalities to those eligible for preferential public healthcare services. Patients would then use these cards when paying their pharmacy bills; behind each card there would be a special account that would be regularly re-filled by the OEP.

2.3 Amendments to the Companies Act and the Company Registration Act

The proposed amendments to Act No.CXLIV on Business Organisations and Act CXLV on Companies Register and on Registration Court Procedures were primarily required for harmonising the legislation with the relevant EU Directives. (Third Directive on the merger of public limited liability companies, Sixth Directive on the division of public limited liability companies, harmonisation with the First and Second Directives on corporate law; proposed amendment to the First Directive on corporate law in relation to electronic company registration procedures).

The draft law contains provisions for the distribution of subsequently found assets of cancelled companies between creditors and provides clearer rules for the procedure of cancellation ex officio. The draft law also contained provisions on European economic interest groupings, in accordance with Directive No. 2137/85 EEC of the European Council.

The Companies Gazette will be made available in an electronic form from the beginning of 2005; the print version will be discontinued and only the electronic version will be available from then on. The First Directive specifies the cases where the foundation of a company is null and void.

In addition to proposals aimed at making certain provisions more specific, we also submitted proposals for the regulations on own shares and for reconciling certain provisions in the Companies Act and the Securities Act. Most of our comments were taken into consideration in Act XLIX of 2003 on amendments to Act No Act No.CXLIV of 1997 on Business Organisations and to Act CXLV of 1997 on Company Registration.

2.4 Electronic company registration process

The proposal and draft law on procedures for the electronic registration of companies and on electronic access to company register documents was submitted by the Ministry of Justice for review in two rounds, in April and May. During the first review we proposed that the proposal specify the rights and obligations of those accepting and using electronic company register documents. We proposed that the proposal specify the ways in which credit institutions should meet their data supply and certification obligations.

During the second round of review we drew attention to the fact that the provisions on the payment of fees and administrative service charges in the proposal were not reconciled with the regulations on payments and the relevant provisions of the Act on the National Bank of Hungary. We pointed out that the solution provided by the draft law was not feasible and was against the relevant payment regulations. We proposed that the issue be reviewed with the National Bank of Hungary and offered banks' cooperation in drafting a viable proposal. We also proposed that the implementation decrees be drafted parallel with the draft law, since the Act would only enter into force as of January 1, 2005.

Unfortunately, the text of the enacted legislation is still not completely satisfactory. Pursuant to Act LXXXI of 2003: "the payment shall be made electronically, at the Service's electronic customer service, through the electronic payment system of the government portal". Detailed rules for the payment of fees and charges will be provided in a separate regulation.

2.5 Transformation of the primary dealers system

Primary dealers in government securities requested the Association to provide a forum and cooperation in developing a new government securities market strategy, with special regard to Hungary's accession to the EU. Also, the introduction of the EURO in a few years after accession will be a key issue and a challenge that will bring major changes to this market segment. An anticipatory strategy developed by Government Debt Management Agency was presented for review at a working meeting on July 2. All participants were asked to present their opinions at the discussion. The most important questions in this context are: what short and long-term measures will be required for an efficient integration while ensuring that the securities market and, in broader terms, the fixed income market, remain in Hungary; what price quotation methods should be applied, what kind of trading system, and when should such system be introduced in order for these objectives to be accomplished.

2.6 Developing the government securities market

The adoption of the European Master Agreement (EMA) ensuring the standard management of repo and securities lending transactions commenced, as part of the measures aimed at developing financial markets in Hungary. To deepen the financial markets it is necessary to develop a standard legal framework for repo and securities lending transactions and to formulate the clauses on risk mitigation in a clear, internationally acceptable and legally enforceable manner.

The proposed Master Agreement is aimed at transposing the parts of the European Banking Federation's „Master Agreement for Financial Transactions" relevant to repo and securities lending transactions. Cross-border transactions are also treated in a standardised manner in the

European Master Agreement. The EMA has been approved by the European Central Bank (furthermore, it is specifically recommended by the ECB and is also used by the ECB in its central banking operations).

The above documents are important from the point of view of developing capital markets in Hungary and virtually indispensable for the smooth integration of the Hungarian financial sector into European money and capital markets.

In this, the Association works closely together with the Association of Investment Firms and the Government Debt Management Agency. The general part of the Master Agreement and the chapter on repo transactions have been completed recently. Based on these, government securities repo transactions with primary dealers have been launched. The chapter on securities transactions will be submitted for review by the banking community soon.

3. Tasks related to Hungary's accession to the EU

3.1 Application scheme for European Structural Funds

Preparations for the efficient utilisation of subsidies and complementary resources from the European Structural Funds will be a top priority in the coming period with regard to Hungary's accession to the EU. The work has commenced under cooperation between the Association and the National Development Plan and EU Grants Department of the Prime Minister's Office. The Operative Programme Management Authorities are also involved in the project. Rules for applications for funding under the European Structural Funds and disbursement rules affecting banks will be developed under this project. A coordination forum will be set up with the participation of the aforementioned institutions and banks affected. This forum will have the task to develop a standard set of bank documents to be used in the application stage (e.g., certificates, and eligible types, of own resources, rules and procedures for guarantees and collaterals, etc.) by drawing on the experience gathered by banks in connection with applications for funding under the Pre-Accession Funds.

Parallel with this, a co-financing working group will be set up to provide potential applicants with information by compiling a co-financing catalogue, specifying the instruments offered by the financial sector, their main features and the financial institutions offering the product.

3.2 European legislation

Directive on market abuse

The European Parliament and Council Directive on Market Abuse and the proposed regulation to implement the Directive were reviewed by the Ministry of Finance with the involvement of other professional organisations, authorities and fellow institutions. Basically, market abuse implies two types of activities: insider dealing and market manipulation. Although the directive on market abuse has not yet been adopted, the drafting of implementation rules has commenced. Three regulations are implied. One is related to the disclosure of inside information and the explanation and definition of market manipulation. Another covers the issues of appropriate disclosure of information and conflicts of interest. A third one provides a detailed presentation of regulations related to share buy-back and securities stabilisation programmes.

Directive on investment services

The Investment Services Directive (ISD) was revised substantially. The new proposal will regulate the financial instruments markets and will apply to investment services and regulated markets. The proposed directive contains a set of operational requirements and licensing procedures for investment firms (no major changes expected in this respect). Investor protection will be tightened. Transparency and integrity will be given special emphasis. Given that the proposed regulation would allow for the creation of alternative markets, other than exchanges, the drafters find it important that prices are published on a regular and continuous basis. The proposal stipulates the rights of investment firms and provides standard rules for operations and settlements on the regulated markets.

Directive on consumer credit

The proposed directive on consumer credit was circulated by the Money and Capital Market Department of the Ministry of Finance in June 2003. A number of provisions of the proposed directive will affect banks' operations. The proposal addresses issues related to advertising, consumer information, data protection, compulsory information to be included in credit and surety agreements and conditions for the termination of agreements. The proposal provides for the concept of responsible lending: before concluding the credit agreement or increasing the credit amount, the creditor should ascertain whether the borrower and the guarantor will be able to meet their obligations under the agreement.

Pursuant to the directive, member states will be required to maintain databases on defaulting debtors and guarantors in their territories. Creditors will have access to these databases and will be able to query other existing commitments of the debtor or guarantor. The directive also addresses issues related to consumer rights in relation to queries (rights to notification and correction). Creditors shall consult the database before granting credit. Creditors operating in other member states shall have access to the database. The directive also makes it possible to set up positive list debtor databases by allowing central databases to include a central register of credit and surety agreements.

III. LOAN SCHEMES

1. Preferential SME loans

1.1 Loan facilities granted by the Ministry of Economy and Transport

As in the previous years, the Ministry of Economy and Transport made available various loan facilities for SMEs, to be awarded under an application scheme and associated with different sizes of non-repayable capital contribution.

One of these facilities is associated not with capital contribution but with interest subsidies. The total allocation for this scheme is HUF 300 million, which, according to the Ministry, can cover 70 to 80 applications. A condition for banks to participate is that gross interest rate may not exceed the central bank base rate (or the 3-month BUBOR) + 4%.

The draft invitation for applications was reviewed by banks; only minor comments were made, as the scheme basically followed the practice of previous years.

1.2 Micro loans

The Ministry of Economy and Transport initiated a further development of the micro loan scheme to involve more bank resources in the scheme.

Responding to this request, the Association, in consultation with bank specialists, developed a set of conditions under which banks could participate with their own resources in the scheme.

1.3 Banking issues related to SME loan schemes

SME loan schemes of the Ministry of Economy and Transport often require the presentation of bank declarations, powers of attorney, guarantee bonds or letters of intent.

Based on banks' proposals we have submitted several initiatives to standardise the required documents.

Since the government has provided an exchange rate guarantee for borrowings by the Hungarian Development Bank, the Hungarian Development Bank can now apply Eurolibor instead of BUBOR when setting its interest rates.

While supporting the main directions of further development of the micro loan scheme, we proposed that the lending limit for classic micro loans be lowered to HUF 3 million, that for Széchenyi Cards raised to HUF 5 million, and banks provide government-subsidised loans between HUF 3 million and 10 million from their own resources (Mini Loans). Under this scheme, borrowers may now also avail themselves of interest and guarantee subsidies for loans with a loan amount between HUF 3 million and HUF 10 million, granted from bank resources (Midi Loans).

2. European Technology Development Programme

The **objective** of the European Technology Development Program is to promote the technological development of SMEs and large enterprises by making available HUF 120 billion to HUF 150 billion in investment loans. Funds for the program are provided through refinancing by the Hungarian Development Bank (MFB). Out of the total allocation, approx. HUF 40 billion has been appropriated for SMEs.

Loans are provided in three forms:

- HUF 10 million to HUF 150 million, for SMEs, with interest subsidy provided by the government;
- HUF 50 million to HUF 1.5 billion, through co-financing (refinancing + banks' own resources);
- HUF 150 million to HUF 1.5 billion, through direct refinancing by the Hungarian Development Bank.

Bank specialists reviewed the **Procedures for the implementation of the program** with MFB in several sessions. Banks failed to agree on distributing the allocation for SMEs. Hence, the issue is now regulated by MFB in a **Framework Agreement**.

Banks challenged the 2% premium as unfair: for any other facility where the risk is with the banks, the premium is 4%, and the same should have been applied in this case, as well; banks felt it important to point out this fact and to emphasise that this provision of the program should not be a precedent in the future.

After several discussions, 21 banks signed up to the Framework Agreement with MFB. The agreement was signed on April 10.

3. Agricultural loans

3.1 Evolution loans

The evolution loan scheme, launched in 2000, was concluded at the end of 2003. The 2,492 applications awarded were associated with loans worth HUF 84 billion in total, of which HUF 37 billion was converted into evolution loans.

Under this loans scheme, if the applicant has accomplished the tasks it has committed to over a period of three years, then the loan is repaid in the form of state support.

As of the end of 2003 there were still 2,280 loans under this loan scheme. Based on the appraisal of the applications, over the three-year period applicants received a total of HUF 37.3 billion in state support, including interest subsidies.

Bank clerks worked really hard during the three years of the loan scheme, reviewing applicants' self-assessments and often correcting errors in the applications submitted; they greatly contributed to the fact that the rate of dropout in the three-year period was less than 10%.

3.2 Settlement of debts of agricultural businesses operating in adverse regions

Parliament allocated HUF 12.5 billion for businesses operating in adverse regions to convert part of their long-term annual loan debts (50%, according to the plan) into 3-year preferential loans, the annual instalments of which would be paid by the state in case the conditions undertaken by the applicants in their accepted applications have been met. However, only those agricultural businesses are eligible for application, whose greater part of land is rated lower than 17 gold crowns. Appraisal criteria also include the rate of employment and public utility coverage in the region.

Despite several discussions, the Ministry rejected our proposal that in cases where the loans to be involved are with several banks, there should be alternative solutions for managing the scheme, other than taking over such loans (this would have been important for both banks and clients).

The Decree and the invitation for applications were issued in April, applications were to be submitted to banks latest by May 15.

3.3 Subsidised loans for frost and drought damages incurred in 2003

Based on the relevant government resolution, the Ministry of Agriculture enacted a decree on a subsidy scheme to mitigate losses incurred by agricultural producers due to frost and draft damages. Under this decree, non-refundable government subsidies to a total value of HUF 10 billion have been made available for producers affected and HUF 30 billion have been allocated for government guarantees for loans granted from banks' own resources. Since the guarantee may not exceed 60% of the loan amount, the volume of loans available under government guarantees is HUF 50 billion.

Government subsidies may be utilised against certificates to be issued by county offices of the Agriculture Ministry to the effect that the damages incurred are within the range set in the decree. (Banks do not have to verify this condition).

The maximum loan amount is HUF 250 million and the loan may be utilised in several stages. Loan applications for damages in summer produce may be filed in the following month, those for damages incurred continuously during the year were to be filed by December.

3.4 Bank guarantees for application fees under loan schemes of the Ministry of Agriculture

The Ministry of Agriculture and Regional Development wants to change the practice of paying application fees in cash: pursuant the relevant EU regulation, application fees are not paid in cash but are to be covered by bank guarantees.

The relevant government decree was drafted in accordance with this concept. To our surprise, bank guarantees were omitted from the draft and only bank suretyships were mentioned. Upon our intervention, bank guarantees were retained in the text as the alternative to cash. In relation to this decree we also emphasised the need to clarify how the list of credit institutions eligible to provide bank guarantees for the transactions in question will be communicated to the competent Brussels committee.

3.5 EU Accession Agricultural Loan Scheme

The resolution on the Accession Loan Scheme was adopted by the government on January 5, 2004. The main elements of this loan scheme are as follows:

- HUF 50 billion from bank resources, with interest subsidy granted by the state
- HUF 50 billion refinanced by the Hungarian Development Bank (MFB) at EURIBOR-based interest rate, with exchange rate guarantee provided by the state (only available for SMEs)
- HUF 50 billion under 100% suretyship provided through the National Development Bank (state suretyship). (From both resources, exclusively for agricultural investment projects).

Banking conditions:

- For bank resources: the 3-month BUBOR effective as of interest date + 2%;
- MFB refinance: EURIBOR + 4% / of which 2 % for MFB, 2 % for the banks/
- MFB guarantee: the 3-month BUBOR + 0.3 %
- MFB refinance and guarantee: EURIBOR + 2.75% /of which 1 % is for the banks/
- Commitment fee, late interest and potential costs related to claim enforcement may be charged after concluding the loan contract.

Banks reviewed the related government submission and draft resolution and the Agriculture Ministry's draft decree in several rounds. Through their comments and proposals they provided substantial assistance in drafting the relevant Government Decree and Government Resolution. With their contribution, professional and clear documents were produced.

At the same time, the banking conditions and, most importantly, interest premiums, have not improved. The 2% interest premium introduced now (versus the 4% applied in the previous years) will probably be a precedent for other loans schemes associated with government support. Therefore, it was imperative to change the Financial and Agricultural Ministries' approach that banks may not charge any costs other than interest. Finally, after a lengthy debate, only those costs arising after conclusion of the loan contract are now regulated in the relevant Government Decree.

Timely implementation of the loan scheme will require special efforts from all banks involved in the scheme.

IV. INTERNATIONAL COOPERATION

European Banking Federation

1. New Basel Capital Accord

Results of the Third Quantitative Impact Study (QIS3)

The Basel Committee conducted a third quantitative impact study in the second half of 2002. Results of the study were disclosed in May 2003. The Study involved 365 banks from 43 countries, including 8 banks from Hungary. Out of the participants, 365 banks used the standardised approach, 159 the foundation IRB approach, 74 the advanced IRB approach. (Some banks completed the exercise for several methods). Banks were split into two groups (large, diversified and internationally active banks with Tier 1 capital over EUR 3 billion, and smaller and, in many cases, specialised banks) and three sub-groups (G10, EU and other countries). Results show that capital requirements increased in all sub-groups using the standardised approach and decreased in almost all sub-groups using the IRB approach. The increase in capital requirements is caused by the capital requirement for operational risk; in the IRB approach this increase is offset by a decrease in capital requirements for credit risk. Capital requirements decreased slightly for the corporate portfolio, more significantly for the retail and SME portfolio; those for inter-bank and sovereign exposures increased a little. Capital requirements for those "Other" countries which applied the standardised approach showed a 12% increase, of which 11% was due to the operational risk charge. The results for Hungarian banks are very similar to the latter group. Combined results for the eight banks show an average 12.2% increase in capital requirements, of which 10.6% is due to the operational risk charge. However, in contrast to global results, in the case of Hungarian banks the capital requirements for the corporate portfolio slightly increased.

Basel II – Third Consultative Paper (CP3)

The Third Consultative Paper of the Basel Committee was issued in April. When drafting this document, the Committee already drew on the results of QIS3. The document contains a number of changes compared to the Technical Guidance to Third Quantitative Impact Study. Accordingly, it will allow the choosing of a simplified standardised approach, which essentially is a synthesis of the simplest options and will offer an alternative for smaller institutions with simpler product structures. The recognition of provisions in the IRB approach has been modified, the risk weight of revolving retail exposures has been adjusted and the treatment of residential mortgages, specialised lending, high volatility commercial real estate loan portfolios, specialised lending, credit derivatives and securitisation has been modified. The weighting of past due loans, under certain conditions, is now more favourable in the standardised approach. The partial use of advanced measurement approaches will be allowed for credit risk and operational risk. In addition, an alternative standardised approach has been offered for the measurement of operational risk. The second pillar has been extended in contents: in addition to banking book interest rate risk, the issues of operational risk, stress test under the IRB approach, the definition of default, residual (legal, documentary and liquidity) risks, concentration risk and securitisation have been addressed in detail. Disclosure requirements under the third pillar have been substantially scaled back, especially in respect of the IRB approach and securitisation. Comments on the Third Consultative Paper were to be submitted to the Basel Committee by July 31.

FBE comments on CP3

In its letter commenting on CP3, the FBE emphasised that for a consistent implementation of the new capital accord, the contents and scope of competence of supervisory reviews (Pillar 2) should be clarified. The new criteria appearing in CP3, to be taken into account by banks and supervisors when determining the capital requirement, will automatically lead to the imposition of an additional capital requirement, not just in special and exceptional cases. This is unacceptable. For a successful implementation of the new Capital Accord, a closer cooperation between national supervisors will be required. Directives of the Accord Implementation Group will not suffice in this respect: the fundamental principles of cooperation between the home and host country supervisors should be laid down in the Capital Accord itself; the notion of Lead Supervisor should be introduced. In light of the results of QIS3, the FBE proposes for national discretions to be substantially reduced. The possible methods for reducing procyclicality should be reviewed in detail prior to the implementation of the new accord.

The FBE's detailed comments on CP3 were provided in an annex to the letter. The most important observations were related to the treatment of revolving retail exposures, equity exposures and securitisation, the recognition of provisions, minimum requirements for applying the IRB approach and the measurement of operational risk.

Comments on Pillar 2

To clarify new issues raised in the second pillar and details of the supervisory review in general, the FBE and the Australian, Canadian, Japanese and U.S. Banking Federations wrote a joint letter to the Basle Committee. The letter explains that the original purpose and the scope of application of Pillar 2 in CP3 are now blurred. The correlation between Pillar 1 and Pillar 2 is unclear, as is the reason for introducing new special exposures. Pillar 2 has shifted in a direction that would lead to an automatic prescription of an additional capital requirement, which is unacceptable. The signatories to the letter expressed their intention to review conceptual issues in Pillar 2 with representatives of the Basel Committee and provided a list of the specific points to be discussed. The meeting with the Chairman of the AIG took place as late as January 2004.

To clarify the purpose of Pillar 2, the FBE, jointly with the ISDA¹ and LIBA², in November turned in a letter to the Chairmen of the Basel Committee and the Accord Implementation Group (AIG). The letter calls for a review of the eight high-level principles³ and for the introduction of a supervisory disclosure régime to ensure uniform practical implementation. On the EU level, the three associations wrote a similar letter to the Chairman of the Group de Contact, members of the Financial Services Committee, the Banking Advisory Committee and key members of the Economic and Financial Committee of the European Parliament.

¹ International Swaps and Derivatives Association

² London Investment Banking Association

³ These principles are:

1. Supervisory review is a firm-driven process and responsibility.
2. The scope of risk assessment should be the responsibility of the institution.
3. Supervisory review should be a dialogue between institution and supervisor.
4. Supervisory review should be the exception.
5. Supervisory action should be justified.
6. Capital is not the only answer.
7. Pillar 2 should be applied at the consolidated level and dialogue should be with the lead supervisor.
8. Supervisory review is a confidential process.

Basel II - other developments

In August 2003, the Basel Committee published a report entitled High-level Principles for the Cross-Border Implementation of the New Accord. In this document the Committee sets six main principles for the division of responsibilities between home and host country supervisions:

- ↪ The New Accord will not change the legal responsibilities of national supervisors;
- ↪ The home country supervisor is responsible for the oversight of the implementation of the New Accord for a banking group on a consolidated basis;
- ↪ Host country supervisors, particularly where banks operate in subsidiary form, have requirements that need to be understood and recognised;
- ↪ There will need to be enhanced and pragmatic cooperation among supervisors. The home country supervisor should lead this coordination effort;
- ↪ Wherever possible, supervisors should avoid performing redundant and uncoordinated approval and validation work in order to reduce the implementation burden on the banks and to conserve supervisory resources;
- ↪ In implementing the New Accord, supervisors should communicate the respective roles of home country and host country supervisors as clearly as possible to banking groups with significant cross-border operations in multiple jurisdictions.

Important decisions adopted at the October 11-12 meeting of the Basel Committee in Madrid were made public in the Committee's press release titled „Significant Progress on Major Issues”. In the press release, the Committee announced that it would not be able to finalise the new capital accord by the end of 2003 and so another 6-month delay was expected.

The principal areas in which the Committee has identified opportunities to improve the proposed framework include the following:

- changing the overall treatment of expected versus unexpected credit losses;
- simplifying the treatment of asset securitisation, including eliminating the "Supervisory Formula" and replacing it by a less complex approach;
- revisiting the treatment of credit card commitments and related issues; and
- revisiting the treatment of certain credit risk mitigation techniques.

The most significant change compared to CP3 and the Technical Guidance to QIS3 is the new proposal on the treatment of expected and unexpected losses under the IRB approach. The capital requirement would be based solely on the unexpected loss portion of the IRB calculations. Accordingly, certain offsets within the IRB framework, in particular future margin income, would no longer be necessary. It is very important, however, that banks provision properly against expected losses. Under this modified approach, banks will compare the IRB measurement of expected losses with the total amount of provisions that they have made, including both general and specific provisions. If the expected loss amount exceeds the total provision amount, the shortfall would be deducted from capital: 50% from Tier 1 capital and 50% from Tier 2 capital. Excess provision amounts, if any, are proposed to be eligible as an element of Tier 2 capital. The Tier 2 eligibility of such excess amounts is proposed to be subject to limitation at supervisory discretion but may not exceed 20% of Tier 2 capital of a bank. The incorporation of this new approach into the IRB framework may require some re-calibration of the framework.

(In January the Basel Committee confirmed that the new Capital Accord will be finalised in June 2004 and issued new and more detailed technical proposals in relation to the treatment of expected and unexpected losses, the framework for securitisation and the principles for the home-host country recognition of AMA operational risk capital.)

FBE comments on the proposed new European Capital Adequacy Directive (CAD3)

Draft Directive CAD3 was published by the European Commission in July (with contents almost the same as CP3). Comments were invited to be submitted by October 22. The Capital Adequacy Working Group was given the task to draft the FBE's opinion. Sub-working groups (consolidation, small banks, operating risk, Pillar 2) were also involved in drafting the response.

In its comments the FBE pointed out that the new European Capital Adequacy Directive should be consistent with the new Basel Capital Accord. Deviations may only be allowed in those issues not addressed by the Basel Committee. However regretful the possible delay in Basel II, Basel II and the European legislative process should continue to be closely coordinated; the time gained should be used by the Committee for consultations with the parties involved on details of the proposed regulation. The FBE supports the idea for the new capital accord to extend to all institutions, irrespective of size. The FBE calls for limiting the scope of national discretions within the soonest possible time.

The regulation should be designed so that it can be properly adjusted to reflect the development of the financial markets and future changes in the Basel Capital Accord. In the FBE's opinion the Directive itself should define the principles and objectives of the regulation and the framework required for the implementation of rules to be stipulated in the Appendix. Technical details will be specified in the Appendix and may be amended under a comitology procedure.

The letter emphasises the need to draw a clear line between Pillar 1 and Pillar 2: Market institutions will have the responsibility to comply with the requirements of Pillar 2; supervisory authorities will have the duty to inspect compliance and to take appropriate measures, including the imposition of additional capital requirements, if necessary. A key issue in implementing the new accord will be the approximation of supervisory practices. To help identify differences during implementation, supervisors will be required to provide information on their own regulatory practices via public disclosures.

The levels of consolidation at which the capital requirements should be met are of fundamental importance. Accordingly, the FBE welcomes that the Commission has revised its previous proposal. The FBE supports the concept of introducing a lead supervisory model under the EU capital reform. All banks should use the same approach when determining their capital requirements; the capital requirement under Pillar 1 should be a single minimum requirement to be applied on a consolidated level for the parent company and its subsidiaries in their home countries, while the second pillar should be applied at the highest consolidation level by the supervisory authority of the parent company's home country. Only in exceptional cases may Pillar 2 be applied in the subsidiary's home country.

USA – Debate over the new regulation

The October decisions of the Basel Committee were largely prompted by recent developments in the United States. The draft of the proposed regulation (Advanced Notice of Proposed Rulemaking, ANPR) was published by the competent U.S. regulators following the respective

Senate committee meetings in late summer. Comments were to be submitted until November 3. U.S. regulators may only approve the final capital accord after a consultative period and following an assessment of the comments received. U.S. regulators maintain their standpoint to only implement advanced measurement approaches for credit and operational risks in the U.S. (AIRB and AMA) and then, only for a limited number of internationally active large banks. As a result of consultations regulators want to simplify the admittedly complex framework (while maintaining risk sensitiveness). It was also stated that the U.S. regulators would conduct at least one more quantitative impact study.

There were some negative opinions heard in the US at the end of the year concerning the new capital accord. The FDIC's Report of December 8 establishes that notwithstanding the Basel Committee's objective to keep overall capital requirements unchanged, risk-based capital requirement would entail a significant reduction in overall capital requirements and the capital requirement for banks applying Basel II would sink below the level required by current U.S. regulations (Prompt Corrective Action). Accordingly, U.S. regulators have two options: ignore Basel II or significantly weaken the current PCA requirements. The FDIC supports setting an explicit floor value for international regulatory capital. This would allow for the new Capital Accord to be less prescriptive in some other areas.

John Hawke, Comptroller of the Currency, in his speech of December 15 expressed scepticism over the finalisation Basel II by mid-2004 and its implementation by end-2006. He pointed out that while the U.S. will do its utmost to have an agreement by mid-2004, it cannot ignore fundamental issues and cannot sweep them under the carpet just to meet the original deadline. Getting a good capital accord is much more important than keeping the envisaged schedule. Apart from the treatment of expected and unexpected losses, a number of other issues also remained unresolved at the Madrid meeting (retail loans, securitisation, mitigation of credit risk). He expressed his hope that the Basel Committee will conduct another quantitative impact study; if not, U.S. regulators will do so.

The above U.S. opinions are not very good signs from the point of view of having an early agreement on Basel II. Remarks on QIS4 also project that U.S. regulators do not rule out the possibility of conducting another review and re-calibration of the New Accord before implementation.

The European directive-making process

The European Commission agreed that the European legislation should not be rushed ahead of the Basel decisions. At the end of November the European Commission issued a consultative note, in which it basically supported the proposal on the treatment of expected and unexpected losses and the fact that the new proposal would not affect the standardised approach, as this will be a strong incentive to use the advanced measurement approaches. However, it emphasised that it is not possible to form a well-founded opinion without knowing the details. The EC was of the opinion that the proposed treatment of unexpected losses does not prejudice level playing field, as differences in national taxation and accounting practices will be offset by the proposed capital adjustment requirements. While accepting the postponement, the EC would like to achieve that an agreement is reached in Basel by mid-2004. Comments on the proposed treatment of expected and unexpected losses were invited by the EC to be submitted latest by December 31.

FBE comments on October decisions of the Basel Committee

In its letter to the European Commission and the Basel Committee the FBE raised a number of issues concerning the treatment of expected and unexpected losses it felt should be resolved before conclusion of the consultation process in December 2003. The FBE would like the Basel Committee to confirm the objectives of the modifications proposed and to have the Committee's position as to how the modification will impact the calibration of the New Accord (any need for re-calibration). The definition and measurement of expected and unexpected losses should also be specified in a clear-cut manner, especially in respect of specialised lending, equity exposures and securitisation, and interactions with different national accounting standards and provisioning rules should be clarified.

The FBE expressed its concern over the proposal to remove the recognition of Future Margin Income for portfolios, where it is an accepted practice to cover expected losses with provisions and margin income. The FBE would like the Committee to explain why it is proposed to recognise excess provision amounts only as an element of Tier 2 capital and why recognition is limited to 20% of Tier 2 capital. The FBE also finds it problematic that the new definition of capital only applies to IRB banks and the Committee's proposed approach would, in practice, require banks using both the Standardised and the IRB Approach to credit risk to apply two different definitions of regulatory capital..

Basel II conferences

A number of conferences and professional forums were held in Hungary and abroad on the Basel Capital Accord and its various segments. Outstandingly important, both in terms of the participants and the presenters invited, were the conference organised jointly by the FBE, the European Savings Banks Group and the European Association of Co-Operative Banks in March and the November conference sponsored by PricewaterhouseCoopers.

2. Other issues addressed by the FBE Banking Supervision Committee

Redefining the tasks and strategy of the Banking Supervision Committee

The Banking Supervision Committee has redefined its strategy and tasks, and roles of its working groups, partly in connection with the approaching enlargement of the EU. A new task set for the Committee is to develop communications between the FBE and the European Banking Committee (Level 2) and the Committee for European Banking Regulators (Level 3) under the Lámfalussy decision-making process.

With the progress made in the rulemaking process, the Basel working group was merged into the CAD 3 working group. Participants proposed that the Financial Conglomerates Working Group should renew its activities to ensure a uniform implementation of the relevant directive.

European Banking Industry Committee

The extension of the Lámfalussy decision-making process to the banking industry called for the European Banking Industry Committee to be set up, as the consultative partner to the European Commission in respect of regulations affecting the banking sector. Founding members of the Committee include the European Banking Federation, the European Savings Bank Group and the European Association of Co-Operative Banks. Representative organisations of other financial

institutions (e.g., leasing and financing firms, building societies, mortgage banks) will also be involved in the dialogue, subject to the topic. The FBE is planned to have 6 votes and the other founding members 4 and 3 votes, respectively, on the committee.

3. Accounts Committee

IAS 32⁴ and IAS 39⁵

The IAS Board met twice in March with the representatives of those organisations which have provided comments on IAS 32 and IAS 39 Exposure Draft.. Consultations with the IASB provided an opportunity for reconciling standpoints; however, most differences between standard-setters and banks (some apparently unbridgeable) remained. Therefore, the FBE and the European Association of Co-operative Banks (EACB) wrote a joint letter to the IASB and the European Commission, giving their standpoints and reservations concerning the proposed standards. Attached to these letters were documents, compiled by the experts of the FBE and the EACB, on macro hedging of interest rate risks, derivative hedge accounting and other key issues related to IAS 32 and IAS 39. Banks challenged the fair value treatment of derivative transactions in the banking book, as well as the IASB's proposals concerning impairment, internal transactions and the derecognition of financial instruments.

Following the March roundtable discussion, the FBE working group met on five occasions with representatives of the IASB. The main objective of these meetings was to develop alternative accounting rules for macro hedging of interest rate risks in IAS 39. As a result of these consultations, the IASB acknowledged the need to develop a treatment that takes account of the banks' practices and allows a portfolio level treatment of macro hedging transactions. At the same time, no agreement was reached as to when should a transaction be considered as efficient and whether or not certain deposit types (such as sight deposits) can be recognised when accounting for hedge transactions.

As a result of the March round-table discussions and other consultations, the IASB revised its standpoint on the treatment of macro hedging and prepared a new Exposure Draft, titled "Fair Value Hedge Accounting for a Portfolio Hedge of Interest Rate Risk". Comments on the new Exposure Draft were invited to be received latest by November 14. The final regulation is expected to be adopted and issued in the first half of 2004. The FBE still does not find the IASB's proposal for macro hedging acceptable as it does not allow the recognition of sight deposits and does not define properly the criteria of effectiveness.

In November, the new President of the ECB turned in a letter to the President of the IASB, drawing attention to problems related to the proposed new standards. In the ECB President's opinion the new standards would adversely impact financial stability. Extending Fair Value Accounting to all instruments will have a procyclical effect and the premature reporting of unrealised value changes would just deepen the shock effects. Average maturity of financial assets may decrease, liquidity and interest risks would shift from banks to customers and the financial system would lose its shock-mitigating ability. It should also be noted that up until now no analysis has been conducted on how Fair Value Accounting will affect financial conglomerates. The application of Fair Value Accounting for instruments that have no market is also questionable. Extending the application of Fair Value Accounting to all instruments would make comparisons between various institutions more difficult and is not in conformity

⁴ IAS 32 Financial Instruments: Disclosure and Presentation

⁵ IAS 39 Financial Instruments: Recognition and Measurement

with the US GAAP. Based on the above, it should be reconsidered whether the option of choosing Full Fair Value Accounting should be adopted in the European standards.

In order to ensure that the technical debate over macro hedging does not hinder the preparations of institutions seeking to implement IAS from 2005, the IASB disclosed the new IAS 32 and IAS 39 standards in mid-December (these do not contain the proposed solutions for macro hedging). The purpose of the review of these two standards was not to reconsider the fundamental approach to accounting for financial instruments. The objectives were to reduce complexity, by clarifying and adding guidance, eliminating internal inconsistencies and incorporating elements of existing Standing Interpretations Committee (SIC) Interpretations and IAS 39 implementation guidance to the standards. According to the IASB, significant improvements have been made in the following areas:

- ↪ There is new guidance on when contracts on an entity's own equity are liabilities;
- ↪ Most loan commitments are now excluded from the scope and so do not have to be measured at fair value;
- ↪ The loans and receivables category is expanded to include purchased loans and receivables (as well as originated ones), recognising that originated and purchased loans are often managed together;
- ↪ There is new guidance given on the calculation of effective interest rates;
- ↪ The derecognition rules have been substantially re-written to clarify their application;
- ↪ Entities have the option to designate at inception any financial instrument as fair value through profit or loss;
- ↪ There is expanded guidance on the measurement of fair value to facilitate implementation.
- ↪ There is clarification that impairment uses an "incurred loss model" rather than an "expected loss model";
- ↪ Hedges of firm commitments are now accounted for as fair value hedges, rather than cash flow hedges. This change converges with the US GAAP;
- ↪ Entities have the option to use the "basis-adjustment" method for hedge of forecast transactions that will result in the recognition of a non-financial asset or non-financial liability. Under this method, deferred gains and losses on the hedging instrument are treated as an adjustment to the cost of the acquired asset or liability.

Experts at the FBE are of the opinion that although the new standards have improved substantially, there are still some unsolved issues not concerning only the treatment of macro hedging transactions, and banking practices are also ignored in some of the solutions (e.g., the treatment of internal contracts, contractual netting, loan derivatives and trading in own shares).

The FBE has not developed a common stance yet on what recommendation it should make to the European Commission concerning the endorsement of the new standards. The FBE's position may largely depend on the solution the IASB will adopt on macro hedging transactions. If the solution concerning the recognition of sight deposits will not be satisfactory, then the FBE will probably recommend that the Commission postpone the adoption of IAS 39 for a year.

Impacts of the IAS on regulatory capital

The Accounts Committee decided to set up an ad hoc working group to assess potential impacts of the new accounting standards on regulatory capital. At its first meeting, the working group mapped those areas where the issue whether regulatory capital and accounting capital should be

determined in the same way or differently may arise (for example: intangible assets, cash-flow hedge, valuation of assets kept for sale, optional use of fair value accounting, treatment of own credit risk, equity/liability classification, trading in own shares, recognition of minority participations, treatment of participations in insurance companies, securitisation, contractual netting, provisioning, disclosure requirements, etc.)

Revision of IAS 30⁶

A committee consisting of auditors, regulators and standard-setters has been set up to review and revise IAS 30. The committee is working closely together with the IASB. The new IAS 30 is intended to rectify problems experienced in the current standard: it will be risk-based and flexible and will extend to all units with financial assets. It will provide rules for disclosure, without addressing any measurement issues. The emphasis will be on the principles of disclosure rather than on setting detailed requirements.

According to the new IAS 30, reports shall contain a descriptive part on the exposure of the unit and the related risk management policies, with quantitative details, all from the perspective of management. Reports shall at least extend to credit risk (asset quality, past due and impaired assets), liquidity, interest rate, market and operational risks. The balance sheet and profit and loss statement shall be compiled in accordance with the measurement principles laid down in IAS 39. The reports will have no compulsory format; however, the idea is to have a standard format within the EU.

The IAS 30 Exposure Draft is planned to be published in the first half of 2004, to be finalised in 2005 and introduced on January 1, 2007.

Ad hoc working group for the implementation of IFRS⁷

The Accounts Committee decided to set up an ad hoc working group to address issues related to the implementation of IFRS (International Financial Reporting Standards). The working group shall map the status of preparations for the implementation of IFRS in EU member states. The working group shall also identify problems related to first application and the main concerns on IAS 39 and other IAS standards.

The strategy of the EFRAG⁸

The founders of EFRAG found it necessary to review EFRAG's activities since its foundation a year and a half ago and to define EFRAG's future strategy. EFRAG's long-term task is to represent European interests in the international standardisation process vis-à-vis the IASB. (This need appeared quite clearly during the debates over the new IAS standards, where, according to general opinion, European interests were pushed into the background). EFRAG should promote the consistent and uniform application of standards, while increasing transparency in its own activities. It should prepare for enlargement of the EU and experts from the accession countries should be involved in EFRAG's activities already at this stage. There is a need to enlarge EFRAG's staff and resources and to enhance dialogue with regulators and the founders of EFRAG.

⁶ IAS 30 Disclosures in the Financial Statements of Banks and Similar Financial Institutions

⁷ IFRS International Financial Reporting Standard

⁸ European Financial Reporting Advisory Group

The role of EFRAG's supervisory board should be strengthened in defining EFRAG's strategy and objectives and analysing the political and economic implications of its proposals (for this latter purpose and Advisory Forum should be set up). Decisions made by TEG (Technical Experts Group) should rely on a simple majority and dissenting views should be documented and published. Cooperation should be enhanced between EFRAG and the EU National Standard Setters. EFRAG's working relationship with the IASB should be improved, transparency should be increased. The European Commission should formally acknowledge EFRAG as the Technical Expert Group set out in the Regulation.

CAD 3 – Market Discipline

In its opinion on Pillar 3 in the Third Consultative Paper, the FBE proposes to further scale back disclosure requirements and to omit certain details which in the absence of proper background information, would confuse, rather than orient, the market. Despite the modifications made in respect of the IRB approach and securitisation, there is still a lot of superfluous and misunderstandable information in the scope.

The disclosure requirements set in the CA Directive are tighter than those provided in Basel II Pillar 3, which is against the objective of ensuring level playing field worldwide. The FBE can only endorse deviations from Basel II where such deviations are required due to the special European legal framework. Likewise, at the national level, deviations may only be allowed in those issues, where deviations are specifically allowed for by the Directive itself. CAD provides for disclosure requirements on individual, and subgroup levels too. The FBE opposes this, because the market would not receive any new information on risks affecting the group. In addition, the FBE disagrees to unnecessary deviations from Basel II in the language of certain provisions of the Directive.

Directive on Transparency Obligations

The latest version of the Commission's new directive on transparency obligations of securities issuers operating in regulated markets was published on March 26, 2003. Although all decision-makers appreciate the importance of this directive, major modifications will still be required for the directive to live up to industry expectations. The most debated issues are: the obligation of quarterly disclosure, the deadlines, the method of disclosure and consistency with other directives.

Opinions vary on whether the benefits of quarterly reporting are higher versus the costs of compiling the reports. Those in favour of quarterly reporting argue that this system is well-proven in the U.S. and ensures a better information of investors; those against it worry about the prevalence of short-term decisions, in addition to the costs involved. The profession maintains that the 90-day deadline for disclosure is too short for presenting audited reports; also, the terms and definitions provided in the new directive should be consistent with other relevant directives, especially the prospectus and investment service directives and the IAS.

No significant progress was made in adopting the directive in 2003. Certain issues are still being debated and there is no strong political will for adopting the directive.

In its opinion provided in November on the directive the FBE pointed out, *inter alia*, the following:

- ↪ the directive may only be implemented after adoption of the new IAS standards,
- ↪ consistency between the directive and other FSAP⁹ directives should be ensured,
- ↪ there is no clarity on home and host country obligations,
- ↪ custodians should explicitly be exempted from disclosure obligations.

Exposure Draft on insurance contract standards (ED5)

The IASB 2003 published its Exposure Draft on Insurance Contracts (ED5) in July 2003. ED5 is the first phase of setting accounting standards for insurance contract. The proposed standards will apply to all types of insurance contract; therefore, it is particularly important that bank assurance aspects be taken into account and consistency with IAS39 be ensured. The FBE and the European Savings Bank Group drew in a joint letter IASB's attention to the importance of consistency of the new standards with internal rules and other standards and to problems arising from the different recognition of assets and liabilities.

Constitution of the IASC Foundation ¹⁰

The Board of Trustees of the IASC Foundation is reviewing the Foundation's Constitution and, in this context, has offered the opportunity for public consultations. Comments may be provided on any provision of the Constitution but are specifically requested concerning the composition and tasks of the Board of Trustees, review of the Constitution and provisions concerning the IAS Board.

4. Economic and Monetary Affairs Committee (EMAC)

The Association represented itself for the first time, through the CEO of one of our large banks, at the meeting of the FBE's Economic and Monetary Affairs Committee (comprising chief economists from large European banks), in April 2003. The meeting reviewed global economic outlooks, the Euro Area, growth forecasts for the U.S. and Europe, monetary policy issues, exchange rate of the EURO and consequences of the war in Iraq.

Members of the Committee met with Dr Ottmar Issing, the ECB Executive Board member in charge of economic and monetary affairs. Issues discussed included the ECB's monetary strategy, the advantages and disadvantages of the system of inflation targets, potential targets for national central banks, potential development of the Euro Area (including economic trends in the candidate countries), reform of the ECB's decision mechanism and transformation of the Governing Council.

EMAC held its 15th meeting in Frankfurt on September 10, 2003. Since this meeting took place just a few days before the Swedish EURO referendum, the Swedish delegate outlined the reasons that might strengthen the No voters: traditionalism, a desire to continue on their own way, the performance of the Swedish economy, exceeding the European average in the past few years, concerns over giving up national sovereignty, populist Anti-EU sentiments, and the crisis of the Stability and Growth Pact (SGP).

The participants reviewed ECB policies and the current situation in the Euro Area. They agreed that in view of the out-gap and low inflation rates, interest rates should be lowered in 2003 and 2004 and proposed an interest cut of 25 base points. Due to the high U.S. deficit, the EURO was

⁹ Financial Sector Action Plan

¹⁰ [International Accounting Standards Committee Foundation](#)

expected to strengthen, another reason for the ECB to relax monetary policy. As for the future of the SGP, some proposed to reconsider the interpretation of "short-term: this would allow member states to exceed the deficit limits, if necessary; others opined that this would undermine the credibility of the SGP. The discussion was resumed at a working lunch offered by Professor Issing.

Professor Issing expressed his opinion that the Euro Area will return to a growth path in the second half of 2004 - this is what growing exports, healthy inflation outlooks, and an increasing financial market confidence indicate. Prof. Issing saw the interest rate cut proposed by the Committee as unnecessary, saying that interest rates are already at a historic low. He considered the U.S. growth as strong but had doubts about the sustainability of this growth. As for the SGP, Professor Issing said that to preserve the credibility of the Pact, excessive deficits should be penalised.

5. Meeting of Associate Members of the European Banking Federation

The Association's Secretary-General attended the 16th Meeting of Associate Members of the FBE in Bratislava. It was confirmed at the meeting that candidate countries would become full members of the FBE upon their accession to the EU. Accordingly, membership fees will change (no major change for Hungary, the increase in fee will be insignificant).

In January 2004, the Association's Board, availing itself of the FBE's offer, wrote a letter to Maurizio Sella, President of the FBE, and Nikolaus Bömcke, Secretary General, applying for a full membership for the Hungarian Banking Association in the European Banking Federation, effective from January 1, 2004. This was the concluding step of a two-year process, during which the Association received a lot of useful information as an associate member of the BFE. The admission process is more of a formal procedure requiring the votes of the Executive Committee and General Meeting of the FBE. The procedure is now in progress.

6. Financial Markets Committee

The FBE's Financial Markets Committee held its 38th Meeting on July 4, 2003 in Rome. The Committee is an important player in the Lámfalussy process, representing the European Banking Federation, and thus, the entire European banking community, in the EU financial legislation process. (Just as a reminder: the legislation process proposed by the Lámfalussy Committee is based on the concept that EU legislation should be adopted through consultation with actors of the sector affected throughout the legislative process. This means a consultation obligation for drafters and legislators, resulting in a regulation adopted based on mutual compromises)

The Committee reviewed the tasks and activities of the various working groups accomplished during the previous four months and determined the tasks for the forthcoming period. A number of draft directives and proposals are in different stages of the legislative process; the related actions required were defined. The Committee addressed current professional issues related to the prospectus directive and the directives on market transparency, investment services, securities settlements, mergers and acquisitions and UCITS, including the relevant position of the European Banking Federation, with special regard to actions to be taken under the Italian presidency.

The 39th plenary meeting of the FBE Financial Markets Committee was held in Dublin (with a view to Ireland taking over EU Presidency).

The plenary meeting reviewed activities and accomplishments of the Financial Markets Committee and its working groups in 2003.

The Committee will be actively involved in Phase II of the European Financial Services Action Plan (FSAP II), working closely together with the European Commission. A conference on the results of FSAP I is planned to be held in 2004.

The legislative and decision-making process aimed at enhancing the integration of capital markets (the Lámfalussy Process) was reviewed by an inter-institutional monitoring group. The Lámfalussy Process will be extended to banking legislation and supervision.

The Ministry of Finance is now getting engaged in the European legislative process and is following closely the activities going on in the various stages and levels of legislation. After accession, the Ministry will have the obligation to develop its standpoints in consultation with actors of the Hungarian capital market sector. Although we are not involved in the EU legislative process as yet, it would be expedient to start developing the institutional framework for the consultative mechanisms required. Accordingly, the Ministry has set up an expert committee, comprising representatives from professional associations of the various market actors (private persons may also participate), the stock exchange, the Central Clearing House and Depository (KELER), international law offices and the Ministry of Justice.

During the consultations held thus far, the proposed transparency directive, mergers and acquisitions directive and UCITS directive were reviewed.

7. 34th Meeting of the FBE Fraud Working Group - Berlin

The following were the main agenda items of the meeting:

- Current directions of crime,
- Launch of a crime prevention magazine,
- Review of the forty recommendations of the FATF,
- Directions of anti-money laundering legislation in the EU member states,
- Issues related to impeding terrorist financing.

The most common fraud methods:

- A new technique in ATM fraud: the **Lebanese Loop**, through which the fraudster gets hold of the card number and code,
- Forging documents required for collecting cash at bank branches (changing the photograph; stealing bank statements, stealing letters; copying card details in shops and restaurants),
- Borrowing by using stolen card details,
- Forging cheques,
- Nigerian begging letters, typically through the Internet,
- Other kinds of fraud through the Internet; for example, offering phones for sale and asking for an advance payment, the goods never delivered..

Annex

Board Meeting Agendas in 2003

Date of Meeting	Agenda
January 20, 2003	<ol style="list-style-type: none"> 1. Proposals for main tasks for the Hungarian Banking Association in 2003 (informal discussion) 2. Submission to the Competition Authority on student loans 3. Report on the settlement of loans of agricultural businesses 4. Proposal for the Association's working programme for the first half of 2003 5. Miscellaneous
February 3, 2003	<ol style="list-style-type: none"> 1. Board election 2003 2. Issues related to changes in supervisory and central bank reporting requirements 3. Proposed amendments to the regulations on electronic signature 4. Report on activities of the Hungarian Banking Association in the fourth quarter of 2002 5. Miscellaneous
March 3, 2003	<ol style="list-style-type: none"> 1. The role of venture capital in the development of SMEs, new strategy of the Regional Development Holding. Presenter: János Kékesi, President & CEO 2. Main tasks for the Hungarian Banking Association in 2003 3. Report on the financial management of the Hungarian Banking Association in 2002 4. Proposal for the 2003 budget of the Hungarian Banking Association 6. Miscellaneous
March 31, 2003	<ol style="list-style-type: none"> 1. Preparations for the Association's Presidium Meeting of April 3, 2003 (verbal) 2. Proposal for a positive list debtor database 3. Membership in ICC Hungary 4. Miscellaneous
June 10, 2003.	<ol style="list-style-type: none"> 1. Initiating a motion to the Constitutional Court on local taxes 2. Problems related to legal counselling (briefing) 3. Setting up a voluntary retail debtor database 4. Update on the review process of the proposed Decree on housing supports 5. "Best Macroeconomic Forecaster" Award 6. Miscellaneous

September 8, 2003.	<ol style="list-style-type: none"> 1. Setting up a voluntary debtor database 2. Formation of a Payment System Forum 3. Cooperation between the Association and the International Training Centre for Bankers 4. Miscellaneous <ul style="list-style-type: none"> ↳ Study sponsorship ↳ Financial management of the Association in January - July 2003 ↳ The Presidium's Working Programme for the fourth quarter of 2003
November 10, 2003	<ol style="list-style-type: none"> 1. Adoption of the European Master Agreement, required for managing standardised repo and securities transactions in the Hungarian securities market 2. Change in ownership of the Central Clearing House and Depository (Budapest) Ltd. (KELER Rt.) 3. Tasks related to the Decree on consolidated regulatory capital and consolidated solvency ratio /Decree No. 23/2003. (X.3.)/ 4. Reconciliation of Act LXIII of 1992 on the Protection of Personal Data with EU Directive No. 95/46/EC 5. Briefing on the Banks' Operative Coordination Forum for Structural Funds 6. Miscellaneous
December 8, 2003	<ol style="list-style-type: none"> 1. Briefing on discussions with the Data Protection Ombudsman 2. Banks' potential participation with regard to KELER's ownership change 3. Miscellaneous