

Report on the Observance of Standards and Codes

Hungary

Prepared by a staff team¹ of the International Monetary Fund and the
World Bank in the context of the Financial Sector Assessment
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REPORT ON OBSERVANCE OF STANDARDS AND CODES

This report contains information on adherence to and consistency with major international standards and codes relevant for the financial sector. The assessment has helped to identify the extent to which the Hungarian supervisory and regulatory framework has been adequate to address the potential risks in the financial system. The assessment has also provided a source of good practices in financial regulation and supervision in various areas.

Detailed assessments of standards were undertaken based on a peer review process, as part of the Financial Sector Assessment Program (FSAP), by Laura Ard (World Bank), Fernand Naert (Belgian Banking and Finance Commission), and Shyamala Gopinath (Reserve Bank of India) for the *Basel Core Principles for Effective Banking Supervision*; Harm-Jan Woltjer (The Netherlands Bank) for the *Core Principles for Systemically Important Payment Systems*; Patrick Conroy (World Bank) for the *International Organization of Securities Commissions' (IOSCO) Objectives and Principles of Securities Regulations*; Dimitri Vittas (World Bank) for the *International Association of Insurance Supervisors' (IAIS) Supervisory Principles*; and Bruce White (Reserve Bank of New Zealand) for the IMF's *Code of Good Practices on Transparency in Monetary and Financial Policies*. The expert team prepared detailed assessments by drawing on information provided by the Hungarian authorities, including self-assessments, and on fieldwork during February and December 2000. This report contains a summarized version of the assessments included in the FSAP report.

The assessments confirm the great progress made by Hungary in assimilating international standards and best practices. Some weaknesses remain, which should be addressed in order to support the strengthening of the financial system's resilience. The recent unification of the supervisory functions into one agency, the HFSA, creates the proper environment and the momentum to address these weaknesses. Common to regulation and supervision of all sectors is the need for (a) more autonomy for the HFSA in the areas of regulatory power and budgetary and staffing matters; (b) stronger enforcement powers of supervisory actions; (c) stronger regulations to instill corporate governance principles; and (d) a swifter move from checklist-driven onsite inspections to risk-based examinations. Specifically for the banking sector, there is need for strengthening risk management capacity in the sector; legal backing to force banks to bring the large credit exposure within the prudential limits; and better disclosure of financial accounts. With respect to the payment systems, the oversight role of the National Bank of Hungary (NBH) should be clarified and changes in the bankruptcy law are needed to recognize multilateral netting. Assessment of the code on transparency in monetary and financial policies revealed that Hungary is at the forefront in trying to achieve a high degree of transparency.

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I. INTRODUCTION AND SUMMARY

1. This report contains summaries of the reviews of compliance and consistency with key principles and standards applicable in the Hungarian financial sector. It reviews compliance with (a) the *Basel* Core Principles for Effective Banking Supervision; (b) the IAIS Supervisory Principles; (c) the IOSCO Objectives and Principles of Securities Regulations; (d) the Committee on Payment and Settlement Systems' (CPSS) Core Principles for Systemically Important Payment Systems; and e) the IMF Code of Good Practices on Transparency in Monetary and Financial Policies. The detailed assessments for each of these standards and codes formed an integral part of the FSAP and were also an input into the FSSA. It should be noted that some of the standards were still in draft form at the time of the assessment, while some do not yet have a complete methodology on which the assessment can be based.¹

2. The assessments confirm the progress made by Hungary in assimilating international standards and best practices. Some weaknesses remain, which need to be addressed to ensure that the regulatory and supervisory frameworks fully support the building up of the financial system's resilience against a background of rapid financial development and integration in the global markets. Driven by the need to be ready for European Union (EU) accession, the authorities are in the process of reviewing the key acts governing operations in the banking, insurance and securities markets. An amended banking act and insurance act took effect on January 1, 2001. The amended securities Act is expected to be promulgated in the course of 2001. An amended NBH Act was submitted to Parliament in March 2001 and approval and implementation is expected in the course of 2001. While these acts address some of the weaknesses indicated in the respective assessments, some other deficiencies still remain to be addressed. While the actual assessments are based on the laws that are currently in force, references are included to modifications envisaged in the amended acts.

3. In light of the fact that since April 2000, Hungary moved to a unified supervisory approach, some of the issues revealed in the respective assessments are identical, as they

¹ The Basel Core Principles were issued in September 1997 and the Core Principles Methodology was released in October 1999 by the Basel Committee on Banking Supervision. The IMF Code of Good Practices on Transparency in Monetary and Financial Policies was adopted by the Interim Committee in September 1999 and the supporting documentation was approved by the Executive Board in July 2000. The draft Core Principles for Systemically Important Payment Systems, including the methodology were issued for comments in December 1999. The final set of principles was issued in January 2001. The IOSCO Objectives and Principles were issued in September 1998 and a detailed self-assessment methodology is being developed. The IAIS Supervisory Principles were issued in September 1997 and a self-assessment program has been developed to assist the members in evaluating compliance.

pertain to the supervisory agency, the Hungarian Financial Supervisory Authority (HFSA). These are:

- The need to strengthen the *HFSA's autonomy*. Significant steps have been taken, such as the procedures to appoint and remove its president, and the publication of a clear mission statement. Other areas in need of improvement include (a) the accountability of the chairman; (b) the HFSA's regulatory autonomy (the HFSA is not empowered to issue any compulsory regulation with general bearing);² and (c) its budgetary autonomy (certain aspects of staffing and pay are controlled by government rules).
 - The HFSA should also further improve its *enforcement* efforts. Weak enforcement of supervisory actions was an issue in some subsectors, notable the securities markets, before the HFSA was established. The unification of the supervisory functions offers an opportunity to move towards applying the highest standards in all subsectors.
 - *On-site inspections* should move away from checklist-driven approaches to risk-based and forward looking inspections. The frequency of inspections should be increased and cycles synchronized among subsectors. With off-site supervision up to good standards, on-site inspections should achieve the same quality.³
 - Stronger legal backing to instill the principles of *corporate governance* is necessary. The definition of roles and responsibilities of boards, executive management, and controlling owners could be further refined. The enforcement sections in the banking act do not hold boards and executive management explicitly responsible for imprudent or abusive activity. Sanctions such as removal from position and/or other remedial actions can only be applied in cases of serious abuse.
4. Specifically in banking regulation and supervision, the following areas need to be addressed:
- The new regulations regarding the *capital charge for market risk exposure*, as promulgated in the trading book requirements (January 2001), should be implemented and enforced as soon as possible.

² Providing the supervisory authority with regulatory power would allow the agency to react faster to international or domestic market developments. Staff was told that some crucial regulations, proposed by the supervisory agency, were stranded for about two years in the government.

³ The problems and fraudulent actions in several brokerage houses at the time of the 1998 Russian crisis went virtually undetected by the inspectors.

- While the definition of *large exposure* limits has been upgraded in the amended banking Act and is now broadly in line with international standards, supervisors urgently need legal backing to impose plans on banks to reduce their excessive exposure. The current situation, where some banks exceed the limits, may create a threat to the soundness of the banking system.
 - Currently, resort to *remedial actions* in case of problems in a bank is predicated too much on an institution being in a crisis or pre-crisis mode. Lack of flexible and effective remedial tools may create moral hazard in the system and potentially deepen crisis situations.
 - *Financial statement disclosure* is required only once a year unless the institution is listed on the stock exchange. Only three banks are listed currently. Disclosure requirements should obligate all banks to disclose their financial statement on a quarterly basis to better harness market discipline.
5. Areas for improvement in securities market regulation and supervision are limited to the following two:
- Over time, the self-regulatory organizations (Budapest Stock Exchange (BSE), Budapest Commodities Exchange (BCE), KELER) should be given more autonomy. Currently they play little meaningful role in regulating important aspects of their respective markets. Also, the HFSA should more actively supervise the self-regulatory organizations.
 - The HFSA should also ensure that accounting standards are applied rigorously by the market participants as part of its on- and off-site supervision.
6. An amended Act on the insurance sector was adopted in 2000, with the aim of establishing broad compliance with EU-Directives. The only insurance sector-specific issue that remains to be addressed is to require insurance companies to establish internal controls for derivative positions

II. REPORT ON THE OBSERVANCE OF STANDARDS AND CODES—BASEL CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION

General

7. The assessment of the regulatory and supervisory framework for banking was performed under the FSAP. The main objectives were to assess the level of compliance with the Basel Core Principles for Effective Banking Supervision and to suggest areas for further improvement.
8. Responsibility for the legal framework governing the financial sector resides with the ministry of finance (MoF) under the oversight of the government. The broad legal framework governing the different sectors is laid down in laws, while government and ministerial

decrees complement these laws. The supervisory authority is only entitled to issue noncompulsory recommendations (resolutions or guidelines).

9. The legal framework for banking and its supervision is set out in the 1996 Act on Credit Institutions and Financial Enterprises (hereafter ACIFE or Banking Act), and the amended ACIFE (2000); and in relevant sections of the Act on the National Bank of Hungary (NBH). The ACIFE defines the responsibilities of the HFSA and the NBH in supervisory matters. Prudential supervision is entrusted to the HFSA—as explained in the Act CXXIV of 1999 on the HFSA—while the NBH’s responsibility is restricted to monetary aspects, liquidity and foreign exchange. The amended ACIFE aims at full compliance with relevant EU directives—even though certain stipulations in the Act will only take effect upon actual accession to the EU.

10. The detailed assessment was prepared by Laura Ard (World Bank), Fernand Naert (Belgian Banking and Finance Commission), and Shyamala Gopinath (Reserve Bank of India). The assessment was based on a review of the legal framework and discussions with the supervisory authorities who cooperated extensively and provided much of the data quoted in the summary—including a self assessment—as well as market participants.

Institutional and macroprudential setting, market structure—Overview

11. Hungary has one of the most developed financial systems among Central and Eastern Europe (CEE) countries. In mid-2000, the banking system consisted of 33 commercial banks, 14 specialized institutions, and 200 cooperative credit institutions. The latter account for less than 6 percent of total bank assets. Foreign ownership in the financial system is very high. Foreign intermediaries own over 70 percent of the equity capital of banks. Ownership by reputable foreign banks enhances the loss-absorption capacity of the sector, and reduces the risk of systemic distress and contagion in a cyclical downturn or in the event of an external or internal shock. Government ownership has been reduced significantly. In the banking sector, the government only owns 17 percent of registered capital through minority stakes and is planning to further divest these stakes. Concentration remains high in the banking system, in particular in the retail sector where competitiveness largely depends on the extent of a bank’s branch network. The largest five banks account for over 70 percent of bank liabilities to households. Despite this high degree of concentration, the degree of competition has increased in all business segments. Finally, domestic financial intermediation remains low. At around 25 percent of GDP, bank credit to the private sector is among the lowest in CEE countries and much lower than in developed economies.⁴ The recent rapid pace of credit growth is deepening intermediation.

⁴ The bank assets-to-GDP ratio in Hungary is low because high inflation in the early nineties and thorough bank restructuring in subsequent years reduced the value of bank assets.

General preconditions for effective banking supervision

12. Since April 1, 2000, Hungary has moved to a unified financial sector supervisory framework. The HFSA was established by the merger of the Hungarian Bank and Capital Market Supervision (HBCMS), the State Insurance Supervision and the State Pension Fund Supervision. This was the final step in an integration process that started in 1997 when banking, and capital market supervision were brought under one roof. The Hungarian authorities saw the unification as a natural response to developments in the financial system, with financial conglomerates becoming the dominant structure. Under the new setting, the authorities aim to achieve an efficient and effective regulatory and supervisory framework to enhance financial sector stability. The Act on the HFSA of 1999 established the agency as a national public administration organization, operating under the direction of the Government and supervised by the Minister of Finance. Although the appointment of the president of the HFSA is by parliament, operation and organization rules are, by law, approved by the Minister of Finance. The authority of the HFSA in granting and withdrawing licenses is complete for nonbank financial institutions. For the banks, the HFSA has to request the opinion of the NBH in case of licensing, and for withdrawing a license, of the NBH and the MoF. The HFSA is not empowered to issue compulsory regulations for the industry under its supervision.

13. The goal of HFSA management is to upgrade financial sector supervision to the principles and practices used by its best developed component—traditionally the banking supervision branch. Over time, the HFSA aims to harmonize the regulatory and supervisory approaches. The new structure calls for five vertical lines of responsibility: financial supervision, authorization and enforcement, complaints and customers relations, coordination and support, and information technology. The first three departments are organized along the sectors of activity: credit institutions, investment services companies, insurance and collective investment vehicles. Oversight of and coordination among these sectors will be ensured by a team of in-house counselors.

14. The regulatory framework for banking and the banking supervision function of the HFSA is largely compliant with the Core Principles (CPs). A significant effort has been made by the authorities to enhance both the quality of the regulatory framework and the functioning of the HFSA and its predecessors in recent years. The ACIFE represented an important effort in adopting international best practices, and additional staffing and training improved the supervisory function. The authorities are aware of the need for further improvement to ensure that those elements critical to effective banking supervision, lacking at present, are put in place. The Hungarian authorities are fully committed to the goal of achieving full compliance with all CPs. The most important change in the amended act is the power to require reporting on a consolidated basis and to conduct supervision on a consolidated basis.

15. Certain areas of less than full compliance may present risks to the stability of the Hungarian financial system. These are: (a) shortcomings in the budgetary autonomy of the HFSA, which may give rise to the possibility of political intervention; (b) the lack of

regulatory powers, which may limit the ability of the supervisor to address, through new rules and regulation, evolving risks in a timely manner; (c) the need for more comprehensive requirements for risk management, more rigorous rules on connected lending and large exposures; (d) stronger focus and supporting rules addressing the nature and quality of board governance and oversight; and (e) the need for effective remedial actions that can be used flexibly. The current delays imposed by the law to use remedial actions may lead to moral hazard in the system and potentially deepen crisis phenomena.

Main findings

16. Autonomy of the HFSA is ensured in several respects. The respective laws fully empower the HFSA to address compliance with laws and all significant concerns of soundness and prudent management. They empower, except for the extreme sanction of withdrawal of a license, the HFSA to take or impose prompt remedial action whenever, in its judgment, a bank is not complying with laws and regulations or is (at risk of) engaging in any unsafe or unsound practice. Staff of the HFSA enjoys full protection under the civil service acts for all acts performed in exercising their professional duties. The president of the HFSA is appointed by parliament.⁵ Dismissal is restricted to some legally-defined cases. The HFSA has published a clear mission statement in the course of 2000.

17. Autonomy could be further enhanced in the following critical areas: (a) accountability of the president is not clearly defined in the Act on the HFSA; (b) budgetary and staffing autonomy is not complete; (c) the HFSA is not empowered to issue any compulsory regulation with general bearing. Legal principles in the country require that it be issued either by governmental or by ministerial decree. The HFSA is only entitled to issue noncompulsory recommendations to the sector; and (d) the need for intervention by the MoF (and the NBH) in the area of licensing and exit policies for banks.

18. The HFSA is required by law to provide information to the NBH, the MoF, the National Deposit Insurance Fund (NDIF), other supervisors (including foreign), and certain government agencies (State Audit Office, Economic Competition Office, Governmental Controlling Bureau), provided the requests for such information are justified in the light of the legal responsibilities of the requesting agency.

19. The Act strictly limits the use of the term “bank” and other similar terms to institutions licensed by the HFSA. The definition of a credit institution adequately reflects the internationally-accepted criteria of deposit-taking and granting of credit. Only banks can perform the full range of protected activities. For other types of credit institutions, the Act restricts the activities to a well-defined list. Comprehensive rules and procedures for the licensing of the establishment and the operation of banking activities are set out in the Act.

⁵ This is a major change from previous practice. The president of the HBCMS—the HFSA’s predecessor—was appointed by the government.

The HFSA is compelled by law to deliberate and decide on any licensing on the basis of both a comprehensive set of confirmed information and onsite examination of the major material aspects (organizational structure, equipment, etc.). The rating system of the HFSA includes an assessment of the capacity of owners or shareholders to support additional equity-funding whenever necessary. For directors and top management, the criteria regarding professional skills, experience, and integrity are laid down in the Act. Strict criteria as to accounting systems, organizational structure, staffing, and logistic and security-functions are verified, largely through onsite inspections, before granting an operational license.

20. Prior authorization is required for each proposed change in ownership or voting rights entailing the breach of limits of 15 percent, 33 percent, 50 percent, or 75 percent. The authorization is also required by any person or group of persons wishing to acquire majority ownership in a company having a controlling stake in a credit institution itself. Any major investment requires approval by the HFSA. Any acquisition by a bank exceeding 15 percent of its equity is prohibited, except for investments in credit institutions or financial enterprises. Furthermore, the ACIFE limits investment in real estate to 5 percent of equity.

21. Regulations on capital set the minimum required capital for a newly established bank, specialized credit institution, cooperative credit institution, and credit institution. Capital requirements and the calculation method of risk weighting are expanded in a MoF decree. If a bank's capital ratio falls below a certain threshold (6 percent, 4 percent, and 2 percent), certain supervisory responses are required. Only in extraordinary cases, can the supervisor require a capital increase.

22. A MoF decree requires banks to set internal regulation for granting loans, making investments, classifying claims, evaluating collateral, and establishing loss provisions. During onsite inspections, the internal regulations, loan underwriting and approval processes, overall loan administration, and level of classified assets are evaluated. The HFSA has the authority to require the bank to change its internal procedures or policies and to adjust the level of provisioning.

23. There are also prudential limits for the exposures to a single borrower and to, "closely related" groups of borrowers. Ten percent or more of a bank's capital is defined as a large exposure. No single borrower or closely related group of borrowers can exceed 25 percent of a credit institution's capital. The aggregate of large exposures shall not exceed 800 percent of the bank's capital. The ACIFE also contains limitations on lending to connected parties and defines the group of connected parties (senior management, external auditor, close family members, or the companies controlled by those persons).

24. Excessive exposure may exist within the system, and is currently deducted from capital as required. However, the overall concentration of risk that such a situation entails for the individual banks and for the system as a whole, should be monitored closely. In order to bring the system into compliance with prudent risk levels, the authorities should consider establishing rules requiring a plan to bring the exposures within the limits through

(a) disallowing new extensions of credit; and/or (b) allowing the sale of portions of the debt to other financial institutions.

25. The Hungarian legislation contains different rules for market risk. The gross open foreign exchange position of the bank may not exceed 30 percent of the bank's capital. A MoF decree regulates the country's risk management and provisioning system. Since April 1, 2001, the government decree on trading book regulation (full compliance with CADI-II) has been in effect/place.

26. The risk management processes are regulated for credit risk, liquidity risk, foreign exchange risk and market risks. The ACIFE defines the responsibility of the board of directors and the supervisory board regarding the existence and operation of internal control systems.

27. The Act details the tasks of the banking supervisory function. According to the act, the HFSA shall conduct a comprehensive onsite inspection at least every two years. The five critical areas reviewed are Capital, Asset Quality, Management, Earnings, and Liquidity (CAMEL) and ratings are awarded. The offsite supervisory system is based on a MoF decree, which defines the structure and content of the regular reports to be submitted by the banks. The offsite supervision is based on a reporting system. An independent group of officials review and analyze the financial condition of banks based on different ratios and through a scoring methodology, and rate banks according to nine categories from AAA to CCC. This information is shared with the supervisor and results compared. In addition, banking supervisors organize regular meetings with management of banks. The supervisor responsible for a bank is constantly in contact with an official of the bank who is designated as the contact point for the supervisor.

28. The Act provides for comprehensive rules on consolidated supervision of credit institutions, but defines the concept of "bank holding company" narrowly by limiting it to groups which are headed by a Hungarian bank or bank holding company. The HFSA has the authority to examine and monitor all companies in a financial or mixed activity group. Risk limitations on large exposures apply fully on a consolidated basis.

29. The accounting standards are broadly in line with International Accounting Standards and EU directives. Financial institutions are required to prepare an annual report consisting of a balance sheet, profit and loss statement, a supplementary appendix, and a business report. Accounts include consolidated accounts for parent company, subsidiary or jointly managed enterprises. The annual reports are required to be audited by independent external auditors. The auditors are required to report directly to the HFSA on the results of their audit if they find serious deficiencies in internal audit systems or violations of internal regulations, violation of laws or regulations issued by ACIFE or NBH. There is scope for improvement of financial disclosure requirements. Banks not listed on the stock exchange should be required to disclose their financial statements on a quarterly basis. Meaningful penalties for material misstatement to the public should also be available to the supervisors.

30. The Act outlines a number of remedial measures and the application details therein. The ACIFE divides the possible sanctions into two groups, according to the seriousness of the breaches. The first group, “pre-crisis,” addresses moderately serious breaches by a financial institution. Remedial actions range from recommendations to the credit institution to assigning onsite resident inspectors to the credit institution. The second group of sanctions addresses more serious regulatory infractions and remedial actions range from requiring the credit institution to increase capital, to ultimately withdrawing the license of the bank, but the latter only with the agreement of the MoF and the NBH.

31. Further legal improvements are needed. Although the HFSA uses remedial tools, the nature, frequency, and effectiveness of supervisory responses fall short of reinforcing strong, effective corporate governance because they are not directed at reinforcing the responsibilities of the boards and senior management to prudently oversee the safe and sound operation of the bank and the consolidated company. The Act does not provide the supervisors with the authority to remove board members and senior management. In addition, the recourse to remedial actions is predicated on an institution being in a crisis or pre-crisis mode. Lack of effective remedial tools may create moral hazard in the system, and potentially deepen crisis situations and should, therefore, be addressed.

32. The HFSA has full authority to allow and supervise cross-border activities of Hungary’s incorporated banks on the condition that a cooperation agreement with foreign supervisors is in place that covers both exchange of information and cooperation in onsite examinations. In 2000, the authorities signed the first such agreement (Memorandum of Understanding, (MoU)). Following the recent enhancement in the principle of consolidated supervision, the authorities should make further progress in this area, by allowing for an acceptable regime of branching out by Hungarian banks. The informal practice in place is rather restricted and does not provide for an effective contribution of the HFSA to consolidated supervision of its foreign-owned banks at the level required by the significance of the phenomenon.

Table 1. Hungary: Summary of Main Findings of Assessment of Implementation of the Basel Core Principles for Effective Banking Supervision

CPs Main Categories	Main Findings
Objectives, Autonomy, Powers, and Resources (CP 1)	Compliance is ensured in many areas. An issue open to further improvement is the autonomy of the HFSA, including the need for clear accountability for its president, for additional regulatory and budgetary autonomy, as well as for full authority in granting and withdrawing licenses.
Licensing and Structure (CPs 2–5)	Broadly follows international standards. The Act imposes strict rules—which grant little judgment to the HFSA—on the potential to acquire participations. HFSA could be given more discretion in this area. Useful improvements could be reached by verifying shareholders’ potential to sustain a credit institution’s equity and tightening the fit-and-proper requirements

	beyond the absence of criminal convictions.
Prudential Regulations and Requirements (CPs 6–15)	Additional modifications to the Act will be needed with respect to establishing clear principles of corporate governance lifting the exception to lending to connected parties on more favorable terms than to nonrelated counterparties; and disclosure of all connected parties, including major shareholders and their direct and indirect business interests. Supervisors also need the authority to establish plans with banks to bring excess credit exposure within the prescribed limits. Finally, even though the Hungarian legislation and the HFSA standards are in line with the basic framework laid down by the Financial Action Task Force on Money Laundering, the legislation and standards are not fully compliant with the CPs, in view of the existence of anonymous deposit accounts.
Methods of Ongoing Supervision (CPs 16–20)	The amended Act has fully embraced the concept of consolidated supervision, an important step for Hungary's supervisory methods.
Information Requirements (CP 21)	Detailed national accounting standards are under preparation and will ensure full compliance with International Accounting Standards. Improvements could be made regarding public disclosure of information by banks not listed on the stock exchange.
Formal Powers of Supervisors (CP 22)	Enhancements are needed. Although the HFSA has remedial tools at its disposal, they are not directed at reinforcing the responsibilities of the boards and senior management to prudently oversee the safe and sound operation of the bank and the consolidated company. Supervisors cannot remove board members and senior management. Recourse to remedial actions is predicated on an institution being in a crisis or pre-crisis mode. Lack of effective remedial tools may create moral hazard in the system, and potentially deepen crisis situations and should, therefore, be addressed.
Cross-border Banking (CPs 23–25)	Following the recent enhancement in the principle of consolidated supervision, the authorities should make further progress in this area, by allowing for an acceptable regime of branching out by Hungarian banks. The informal practice in place is rather restricted and does not provide for an effective contribution of the HFSA to consolidated supervision of its foreign-owned banks at the level required by the significance of the phenomenon.

Authorities' response and recommended next steps

33. The Hungarian Authorities were in broad agreement. They stressed that the amendments to the ACIFE marked significant progress towards EU compliance and international standards. They agreed that some further steps need to be taken to achieve that latter goal. On the autonomy of the HFSA, the authorities made two points: (a) negotiations

with the government are still ongoing regarding the specifics of the accountability of the HFSA president and the HFSA's power to issue binding regulations to the financial sector; and (b) the MoF was of the view that more budgetary autonomy for the HFSA was not seen as a priority at this point. Staff disagreed with the latter point, pointing out that full autonomy in budgetary and staffing matters would be beneficial for the effectiveness of the supervisory function. The authorities were also of the view that the amount and nature of remedial tools were sufficient to tackle troubled banks.

III. REPORT ON THE OBSERVANCE OF STANDARDS AND CODES—IAIS INSURANCE SUPERVISORY PRINCIPLES

General

34. The assessment of the Hungarian insurance sector supervision was performed as part of the FSAP for Hungary. The main objectives were to assess the level of observance with the IAIS Supervisory Principles and to suggest areas where further development may be appropriate. The assessment was done on the basis of the draft IAIS principles (February 2000).

35. Insurance operations are governed by Act XCVI on Insurance Institutes and Insurance Activities of 1995 (the Insurance Act). The Act XCVIII of 2000 on the amendment of Act XCVI of 1995 aligns insurance regulations with EU standards. Since April 2000, the HFSA is responsible for oversight of the insurance sector. Its operations are defined in the Act on the HFSA (1999) and further explained in its publication on fundamental principles of supervision.

36. The detailed assessment was prepared by Dimitri Vitas (World Bank). The assessment was based on a review of the legal framework and discussions with the supervisory authorities (The HFSA and its predecessor responsible for insurance company supervision) who cooperated extensively and provided much of the data quoted in the summary, and market participants.

Institutional and macroprudential setting, market structure—Overview

37. Starting from a state monopoly in the mid-1980s, the insurance sector progressed through institution building and crisis resolution. The sector has gone through a long process of consolidation. In 1992, the sector was technically insolvent but extensive restructuring, privatization, and recapitalization through strategic foreign investors restored financial and managerial soundness. Many new products were introduced, including the very successful unit-linked policies, and life business has grown at a brisk rate. Both the life and nonlife sectors are highly concentrated, although different companies are market leaders in each sector. Insurance profitability recovered and is now positive overall. Mutual insurance companies account for a very small share of the business, but play a very useful part in what could be described as micro-insurance. Competition is still weak and operating costs are twice the international average.

General preconditions for effective insurance supervision

38. Hungary is broadly compliant with most of the insurance supervisory principles, but improvements in some areas would be recommended. The HFSA has an active offsite surveillance function and also undertakes regular onsite inspections. More comprehensive investigations are conducted when required. The supervisors actively provide input in the preparation of insurance acts and regulations but the actual drafting of laws and regulations is the responsibility of the MoF. The supervisor has extensive intervention powers and has been successful in the restructuring and rescue of weak insurance companies and associations, often arranging for their absorption by strong insurance companies. The two main areas to be addressed are the need for legal powers to enforce principles of corporate governance in insurance companies and to require the establishment of internal controls of derivative positions.

Main findings: summary

39. The HFSA has exclusive authority to license insurance companies. The licensing requirements include a minimum security capital that varies by line of business, passing of the fit-and-proper test by owners and senior managers, and detailed business plans. Foreign companies are not allowed to operate local branches but they may establish local subsidiaries. The required minimum security capital equals Ft 250 million for life insurance and varies between Ft 150 million and Ft 350 million for different lines of nonlife business. Applications for a license must include a detailed business plan with projections of revenues and costs as well as assets and liabilities (including shareholder and policyholder funds), and the projected solvency margins. The business plans must be verified by an external auditor and an actuary. The fit-and-proper test requires that all directors and senior managers have a clean criminal record, good reputation, and appropriate professional qualifications and experience. The HFSA must be satisfied that the proposed shareholders have the means to provide the minimum start-up capital as well as the ability to provide further capital for the insurer when required. The agreed IAIS principle does not require the consent of the home supervisor for granting a local subsidiary license to a foreign company. All the foreign insurance companies authorized to participate in the Hungarian market are of high reputation and solvency.

40. Prior preliminary approval of the HFSA is required for any change in ownership of an insurance company that results in a potential change of control. An application is required that sets out the financial standing, professional reputation, and business interest of the prospective investor. HFSA approval is required when stakes amounting to 25 percent or more of the value of issued shares are acquired. When a foreign investor is involved, the supervisor may contact the home supervision authorities to verify the solvency and appropriateness of the foreign investor's participation in the ownership and control of the Hungarian company. However, there is no requirement to obtain the consent of the home supervisor.

41. The Insurance Act spells out the responsibilities of the supervisory and management boards. However, there is no requirement for the presence of independent executive directors. In most of the foreign-owned companies, the supervisory board comprises representatives of the parent company. There is, therefore, inadequate presence of independent directors. Insurance companies must appoint an external auditor and notify the HFSA of the appointment. Insurance companies must also appoint an actuary who must verify all actuarial returns and business plans that are submitted to the supervision agency. There is no requirement to appoint an external custodian. However, insurers must appoint an internal auditor with duties that are similar to that of a compliance officer. The annual report of the internal auditor must be submitted to the HFSA.

42. Although the duties and responsibilities of board directors are clearly spelled out, the provisions on corporate governance and the lack of emphasis on the presence and role of independent directors do not provide adequate safeguards for the protection of both policyholders and minority shareholders. However, it should be noted that the draft IAIS standard itself was not yet fully developed in this area. Legal provisions to enforce corporate governance need to be strengthened for all sectors of Hungary's financial system.

43. During onsite inspections, supervisors examine the adequacy of internal policies and controls on risk management, record keeping, calculation, and maintenance of reserves, etc. Large insurance companies, especially the foreign-owned ones, have effective internal controls, often supervised by head office units. The approach of small companies and insurance associations is less developed, although given the very small size of their asset base, there is little concern about systemic risks. Supervision could benefit from the development of an offsite manual with clear conduct guidelines to assess the effectiveness of internal controls used by both foreign and domestic large companies.

44. The Insurance Act places clear upper limits on the holding of different asset classes as well as individual securities. There is also a minimum investment requirement in state bonds. The purpose of these limits is prudential but there is no general reliance on the "prudent person" rule. However, the act requires insurers to diversify their investment risks. Insurers are not required to use the services of external custodians.

45. The Insurance Act and regulations clearly specify the composition of liabilities, the inclusion of different types of claims, and the setting up of different types of reserves. Annual actuarial reviews are required to be submitted. Although there is no manual on the methodology for setting actuarial reserves and for building a minimum level of financial resilience, the act requires insurance companies to report their actuarial assumptions and justify their internal calculations.

46. Hungary applies the EU standards on minimum capital and solvency margins for both life and nonlife insurance. These are clearly defined. However, capital requirements are not weighted by risk and no stress testing is applied.

47. The Insurance Act specifies that the use of derivatives and asset swaps is permitted only for hedging purposes. It is specifically stated that such use should not jeopardize the security capital of the insurer. However, there is no reference to the safety of technical reserves, disclosure requirements are not spelled out, and the establishment of adequate internal controls and monitoring of derivative positions is not emphasized. Use of derivatives is mostly linked to financial assets. Their use is not permitted in connection with insurance liabilities even though such use could provide a better hedge than the safest investment asset. In this, Hungarian regulators follow accepted international practice. The Hungarian authorities should consider the introduction of prudential regulations on the use of derivatives.

48. Domestic reinsurers are subject to the same regulatory regime as direct insurers. No retention ratios are imposed and there is no requirement to reinsure with a state-owned reinsurance company. Reinsurance arrangements are reviewed at the time of onsite inspections. The supervisor may require the cession of part of particular risks to reinsurance. Insurers are expected to consider the security of their reinsurers. Reinsurance cover from foreign reinsurers, which are not established locally, is not taken into account in calculating the solvency requirement of insurers.

49. Insurers must submit their externally audited annual report as well as a report produced by the internal auditor. The latter is not published. They also provide quarterly returns. These must be submitted in both electronic form and hard copy. Insurers must also inform the HFSA without delay of their inability to meet their obligations or their failure to maintain the required technical reserves or minimum capital. The forms are specified by the HFSA, which undertakes offsite analysis. An early warning system is under elaboration but not yet in place.

50. The HFSA undertakes regular inspections of all insurers once every five years. Under the new Act the frequency is increased to once every two years. The HFSA has the right of access to all records and files and is entitled to request any additional information in the conduct of its inspections.

51. The supervisor is empowered to take remedial action if insurers do not comply with any provision of the Act. They have the power to restrict the business of an insurer or to direct an insurer to stop unsound practices as well as the power to order a reorganization plan or to revoke the license of a noncomplying insurer.

52. The HFSA is (as was its predecessor) an active participant in the IAIS but has not entered into agreements or MoUs with insurance supervisory authorities in other countries. As part of the new integrated supervisory agency, information-sharing agreements with other countries are likely to be prepared. Insurance supervisors are subject to professional secrecy and are required to hold confidential information received in the execution of their duties.

Table 2. Hungary: Summary of Main Findings of Assessment of Observance of the IAIS Insurance Supervisory Principles

Subject	Main Findings
Organization of an Insurance Supervisor (CP 1)	Independence of HFSA is ensured in several areas. HFSA could benefit from a higher degree of budgetary autonomy and from regulatory autonomy. Modalities of accountability of the president of the HFSA are under discussion. Compliant in all other areas.
Licensing and Changes in Control (CPs 2-3)	HFSA has full authority for licensing insurance companies and withdrawing licenses.
Corporate Governance (CP 4)	The legal framework to enforce corporate governance in insurance companies needs to be strengthened. The new Act did not address this crucial topic.
Internal Controls (CP 5)	Development of an offsite manual with clear conduct guidelines to assess the effectiveness of internal controls used by both foreign and domestic large companies would help the supervisors in assessing the companies' internal control systems.
Prudential Rules (CPs 6-10)	No major actions required. The HFSA does not apply risk-based capital requirements, nor a dynamic solvency test, but neither of these is explicitly required by the IAIS standard.
Market Conduct (CPs 11)	The lack of prudential regulations on the use of derivatives should be addressed. The new Act has not taken any initiative in this regard.
Monitoring, Inspection and Sanctions (CPs 12-14)	No actions required. Increasing the frequency of onsite inspections from five to two years, as envisaged in the new Act is a welcome development.
Cross-border Business Operations (CP 15)	No action required
Supervisory Coordination and Cooperation, and Confidentiality (CPs 16-17)	No action required. The HFSA is taking initiative to intensify cross-border coordination and cooperation.

Authorities' response and recommended next steps

53. The authorities are in broad agreement with the assessment. They underlined the critical new steps embedded in the new Act, in effect since early 2001. It is recommended that the two main areas of noncompliance be addressed in due course. As discussed above, the lack of legal powers to enforce principles of corporate governance in insurance companies is an issue that is common to all sectors of finance in Hungary, and, as a matter of fact, in most transition economies at this stage.

IV. REPORT ON THE OBSERVANCE OF STANDARDS AND CODES—IOSCO OBJECTIVES AND PRINCIPLES OF SECURITIES REGULATION

General

54. The assessment of the Hungarian securities regulations was performed as part of the FSAP assessment for Hungary. The main objectives were to assess the levels of observance with the IOSCO Objectives and Principles of Securities Regulation, and to suggest areas where further development may be appropriate.

55. The detailed assessment was prepared by Patrick Conroy (World Bank). The assessment was based on the authorities' self-assessment, a review of the legal framework and discussions with the supervisory authorities who cooperated extensively and provided much of the data quoted in this summary, and market participants.

Institutional and macroprudential setting, market structure—Overview

Supervisory framework

56. Supervision of the Hungarian capital markets and its participants rests with the HFSA. With respect to the capital markets, HFSA has supervisory authority over the BSE, the BCE, KELER (the securities settlement system), securities intermediaries, issuance of securities to the public, and investment fund managers. Given the relatively brief history of capital market regulation in Hungary, the markets appear to be well-regulated and the HFSA and its predecessor have made great progress in supervising the sector.

57. In its supervisory capacity, the HFSA is guided by the following pieces of legislation: the Act CXXIV of 1999 on the HFSA; the Act CXI of 1996 on the Floating of Securities, Investment Services (currently under revision); the Act XXXIX of 1994 on the Commodities Exchange and transactions effected on the Commodities Exchange; the Act LXIII of 1991 on Investment Funds; and the Act CXII of 1996 on Credit Institutions and Financial Enterprises (ACIFE) (as amended in 2000).

Market structure

58. Hungary's securities markets have grown dramatically in recent years. The overall market capitalization of the BSE has increased from Ft 884 billion in 1994 to Ft 7,306 billion in 1999. Much of this growth can be attributed to the privatization of state-owned enterprises and the increased listing of government bonds and bills on the BSE. The basic infrastructure of the market consists of two exchanges (the BSE and the BCE), a central depository and clearing institution, KELER, and 73 investment companies acting as market intermediaries. Government bonds and treasury bills dominate the fixed income securities markets. Nongovernment bonds listed on the BSE have a market value of only Ft 80 billion. Trading in bonds takes place both through an electronic trading system on the BSE and "over-the-counter" (OTC).

General preconditions for effective securities regulation

59. Hungary's securities regulatory regime conforms in most material respects with the implementation of the IOSCO Principles. The assessment identified certain outstanding issues relating to implementation of the Principles. The main areas of concern with respect to the regulatory framework are (a) shortcomings in the HFSA's budgetary and regulatory autonomy; (b) the limited level of oversight autonomy given to the Self Regulatory Organization (SRO); and (c) the inadequacy of enforcement regulations. The current revision of the securities Act intends to address several of these issues. With respect to the supervisory function, there is a perception in the market that compliance with accounting and auditing standards is low and that enforcement by the supervisors of these standards is not strong enough. More generally, the perception exists that the enforcement efforts of the supervisors—in particular the HFSA's predecessor and the SROs have to date proven to be inadequate and that the disciplinary program conducted by the supervisors is too lenient in imposing sanctions. It is recognized that these weaknesses were associated with the 1998 failure of several brokerage houses. Efforts have since been undertaken to address these weaknesses, more particularly since the establishment of the HFSA.

Main findings

60. The HFSA does not possess the powers to issue regulations, but it has sufficient powers to perform its functions. The HFSA has the power to carry out off-site and on-site supervisions. The HFSA's organizational structure, operations, and authority are generally consistent with the relevant portions of the Principles. Improvements are recommended regarding the adequacy of staff resources to meet the increasing supervisory demands,⁶ regulatory independence, and enforcement capabilities.

61. Hungary employs a reasonably well-developed scheme of self-regulation in its capital markets, and relies to a limited extent on SROs to fulfill some regulatory functions. Both the BSE and the BCE are deemed SROs under relevant legislation. However, it appears that BSE and BCE play little meaningful role in regulating important aspects of their respective markets. All rules of the BSE and BCE must be approved by the HFSA prior to their taking effect, and are enforced by the respective exchanges against their members. The exchanges are also limited in the scope of their "self-regulatory" powers. For example, the BSE employs limited electronic surveillance capabilities. Second, each exchange has limited capacity (and authority) to investigate and discipline its respective members in the case of suspected rule infractions. In most cases it is the HFSA that investigates such activities and sanctions members when found culpable. BSE and BCE do not possess adequate powers to sanction misconduct in the sector. As compared with many international markets where SROs play an

⁶ These concerns stem in large part from the deficiencies identified during the 1998 Russian crisis when growing problems in 12 brokerage firms went virtually undetected by the supervisors during their inspections of these firms.

integral role in the regulatory process and possess quasi-legal authority in that regard, the BSE and BCE appear to function in a manner resembling more a private membership club.

62. By law, the HFSA is authorized to inspect and investigate organizations subject to its regulatory oversight. It does not, however, possess the authority to investigate possible criminal activities. The HFSA is also empowered to inspect books, documents and other relevant information or to request the submission of extraordinary reports, statements, audit reports. The HFSA can assess fines, temporarily revoke a license or appoint a supervisory commissioner, and initiate and conduct full-scale administrative proceedings/inquiries. Current requirements applicable to market professionals is deemed weak. More detailed and stricter reporting should be introduced. There is a market perception that the enforcement efforts of both the HFSA (more specifically its predecessor) and the SROs have to date proven to be inadequate. The HFSA's more direct involvement in these activities might serve to strengthen the overall enforcement profile of the Hungarian capital markets.

63. Both the HFSA and the NBH collect information on financial sector participants. In addition, information-sharing MoUs have been entered into with the regulatory and supervisory authorities of about ten countries. Pursuant to international agreement, the HFSA, upon receiving an appropriate request, may immediately transmit all information that is not qualified as a business secret and/or security secret. The HFSA is subject to strict business and security secrecy rules, and must seek an appropriate exception should it wish to have such requirements waived.

64. Hungarian disclosure, accounting, and auditing standards are largely compliant with the relevant international standards. The MoF continues to work towards harmonizing Hungarian standards with international ones. Issuers are required to disclose financial and other information on a regular basis. They are also required to disclose information in cases where there is reasonable likelihood the information may have an effect on the value or yield of a security. Market stakeholders suggested that the monitoring of compliance with, and enforcement of, such reporting requirements should be enhanced. Issuers are required to disclose publicly changes in ownership structure. The provisions of applicable laws as well as the protections afforded to minority shareholders are in line with those in other developed international markets.

65. The HFSA is the sole authority to license investment fund managers. A license may be granted only to those companies whose activities are limited exclusively to fund management activity and/or pension fund management activity. Both qualitative and quantitative criteria are applied. The investment fund manager is required to employ an independent custodian. Eligible custodians are limited to banks approved by the HFSA. Investment fund managers and custodians must not have a direct and indirect share of each other's ownership greater than 10 percent. The HFSA may carry out on-site inspections of the fund manager and the custodian prior to granting a license, and at any time thereafter during the effectiveness of the license. Disclosure requirements of investment funds are regulated by the Act of 1996. One requirement regarding the public offering of investment units is that the fund manager must first publish a prospectus containing prescribed

information. The prospectus must contain all information necessary to enable an assessment of the operation, investment principles and management of the investment fund, as well as of the risks associated with the investment fund.

66. Investment service activities may be engaged in only after the granting of an appropriate license by the HFSA. Basic entry standards are prescribed for all investment service providers. Applicants must satisfy various technical requirements, requirements applicable to personnel as defined in the Act and in government decrees issued pursuant thereto. An independent auditor is required to substantiate the suitability of the applicant's information systems, which must be capable of providing among other things, an accurate depiction of the firm's financial position. Specific entry requirements are set up for each type of investment firm. Investment firms applying for licenses from the HFSA are required to provide proof of having joined the Investor Protection Fund and provide the name of any other entities in which the applicant has a shareholding, the particulars of their internal accounting policies and procedures; and substantiate the suitability of their business record keeping and control systems. Both initial and ongoing minimum capital requirements are imposed on market intermediaries.

67. Prior to issuing a license, the HFSA must approve the general contractual conditions, procedural rules applicable to the prevention of money laundering, internal control rules and procedures relating to the physical safety of assets and other data, and the procedural rules relating to the handling of securities on deposit. Any amendments to these rules and procedures must also be approved.

68. The HFSA may appoint one or more supervisory commissioners to assume control of any distressed investment if the firm appears unable to meet its obligations; its board of directors, (or any executive) is not capable of fulfilling its responsibilities and it poses risks to investors or the markets; or the deficiencies in the firm's accounting or internal control systems are of such gravity that assessing accurately the financial position of the enterprise becomes unlikely.

69. Act. No. CXI of 1996 organizes the Floating of Securities and Investment Services. The rules applicable to the BSE trading system are adopted by the BSE itself. The BSE is a self-regulating, self-governing body under the rules of the Act. This act also deals with market manipulation and other unfair trading practices. According to the Securities Act a fine may be levied on those who manipulate the market or engage in insider trading. According to the Penal Code confinement up to three years may be imposed on a person who engages in insider trading.

70. The HFSA monitors market activity independently of the BSE. It does not rely exclusively on information obtained from the BSE, but performs market surveillance of unusual price movements itself. Given the widespread perception that significant amounts of market manipulation go virtually undetected or inadequately sanctioned, vigorous market surveillance by HFSA is essential.

Table 3. Hungary: Summary of Main Findings of Assessment of Implementation of the IOSCO Objectives and Principles of Securities Regulation

Subject	Main Findings
Principles relating to the regulator, (CPs 1–5)	Improvements are recommended regarding the adequacy of staff resources to meet the increasing supervisory demands, regulatory independence, and enforcement capabilities.
Principles of self-regulation (CPs 6–7)	Over time, more powers should be delegated to the SROs.
Principles for the enforcement of securities regulation (CPs 8–10)	Whereas the Act provided the supervisor with all necessary tools to enforce actions, there is a perception in the market that the enforcement efforts of both the supervisors and the SROs have to date proven to be inadequate and that the disciplinary program conducted by the supervisors is too lenient in imposing sanctions. The HFSA should address these deficiencies.
Principles for cooperation in regulation (CPs 11–13)	No action required.
Principles for issuers (CPs 14–16)	There were suggestions from market participants that there has been a certain degree of abuse associated with “arbitrage” between domestic and international standards and that compliance with the standards is relatively low. The HFSA must be vigilant to ensure that this practice does not serve to undermine market confidence.
Principles for collective investment schemes (CPs 17–20)	No action required.
Principles for market intermediaries (CPs 21–24)	The Hungarian capital requirements are generally consistent with the Principles and similar requirements in place in other developed markets. The EU’s Capital Adequacy Directive has been fully implemented in Hungarian law in early 2001.
Principles for the secondary market (CPs 25–30)	No action required.

Authorities' response and recommended next steps

71. The authorities were in broad agreement with the assessment. The new Securities Act, currently under preparation, will increase compliance with EU directives. Most pending issues raised in the above assessment refer to (a) either issues that are common to most sector of the financial system—autonomy of the HFSA, enforcement powers, corporate governance; or (b) to improvements in supervisory practices such as enforcement of actions and sanctions and of accounting practices. It is expected that the HFSA will address these perceived weaknesses at a time when Hungary’s capital markets are at a critical stage of development, when it is important that the markets are allowed to grow in a sound and efficient manner.

V. REPORT ON THE OBSERVANCE OF STANDARDS AND CODES—CPSS CORE PRINCIPLES FOR PAYMENT SYSTEMS

General

72. The assessment of Hungary's payment and settlement systems was performed under the FSAP for Hungary. The main objectives were to assess the level of compliance with the Core Principles for Systemically Important Payment Systems issued by the Basel CPSS, and to suggest areas for further improvement.⁷

73. The legal framework governing establishment, operation and membership of the respective payment and settlement systems is set out in sections of the Acts on the NBH, on Credit Institutions, and on Securities markets.

74. The detailed assessment was prepared by Harm-Jan Woltjer (the Netherlands Bank) and was based on a review of the legal framework and discussions with staff of the NBH and payment and settlement systems, and representatives of other institutions and agencies involved. These staff cooperated fully with the conduct of the assessment.

Institutional and macroprudential setting, market structure—Overview

75. Hungary has developed a variety of payments and settlement systems, for retail payments, large value transfers, card payments, as well as for OTC securities, stock exchange transactions in securities, and derivatives trades. There are no systemically important netting schemes in Hungary in the payments areas and, therefore, the financial system is not threatened by an unprotected netting scheme for payments. The two main payments systems for large value payments are VIBER and the Interbank Giro System (IGS).

76. The payment and settlement system is well organized and efficient for large values as well as for retail payments. In the OTC market, securities trades can be settled within 7 to 45 seconds after the trade has been matched on a trade-for-trade basis. Delivery versus payment (DVP) is achieved by an online connection between the real time gross settlement system of the NBH and the securities settlement system of KELER, which also operates in real time mode. On the other hand, the systems seem relatively costly for their users, especially the payments systems. Not only is the tariff still relatively high (mainly because the markets are relatively small), the gross settlement of retail payments also calls for a large amount of liquidity and could give rise to high funding costs. This does not yet seem to confront banks with high opportunity costs as they can use their reserve requirements for this purpose. As reserve requirements are likely to come down in the run-up to European Monetary Union (EMU), this might create problems.

⁷ At the time of the assessment, February and May 2000, these principles were still in draft form. However, there are no substantial differences between the final principles and the draft principles.

General preconditions for effective payment systems

77. Three payment and settlement systems are of systemic importance and comply in most aspects with internationally published standards—though there are areas for improvement. The Hungarian large-value payments system, VIBER, complies with the Core Principles for Systemically Important Payment Systems.⁸ VIBER operates on a real time gross settlement basis. Although the system complies with the CPSS-principles, the NBH is exposed to credit risk due to the present legal provisions on pledges. The NBH also complies with the CPSS principles for payments system oversight. The IGS is the system for the clearing and settlement of third party credit transfers, operated by the Giro Clearing House. Owing to its monopoly position, the volume of transactions, and its daily turnover, the IGS is a systemically important payment system and works as a deferred gross settlement system. The IGS complies with the CPSS core principles. Finally, KELER is the Central Clearing House and Depository (Budapest) Ltd. which acts as the National Central Securities Depository (CSD) and provides settlement services to the OTC market, the BSE spot market and the derivatives markets of the BSE, and the BCE. From an operational and organizational point of view, KELER broadly complies with the set of recommendations for securities settlement systems published by the joint CPSS-IOSCO task force. Issues to be addressed pertain to the legal basis for (a) multilateral netting and (b) collateral arrangement used for risk-management, which are not sound and needs to be strengthened.

78. The main challenge for the systems based on the netting principle comes from the fact that multilateral netting is not recognized under the bankruptcy law and procedures, and that the legal provisions on repos and pledges are, at a minimum, unclear.⁹ Hence, the safeguards provided in the netting systems in Hungary may not be as robust as they look, and thus pose problems.

Main findings regarding VIBER and IGS

79. The NBH Act entitles the NBH to provide settlement facilities and to act as system provider for a real time gross settlement system. Rights and obligations of the system provider and of the participants are based on contractual arrangements. These contracts

⁸ VIBER has been developed to handle interbank large value transactions, transactions in banknotes and coins between banks and the NBH, and to settle securities transactions on a pure DVP basis. It also forms the infrastructure for the implementation of monetary policy and for the settlement of positions stemming from other clearing and settlement systems. Since 2000, the system has also been used to settle urgent client-to-client transactions with same-day-value.

⁹ Work is in progress to address these issues. The insolvency legislation will be amended in the course of 2001 to recognize the principles of multilateral netting in payment and settlement systems.

regulate the irrevocability and finality of payments in VIBER. There are no obstacles to the enforceability of these contractual arrangements, stemming from the provisions in the bankruptcy law. This law does not contain a zero hour rule” i.e., a bankruptcy decision by the court has no retroactive effect for Hungarian based banks. However, the system is also open to branches of foreign banks and a problem could arise if branches of banks based in a country with a zero hour rule might apply for membership. At the moment there are none. Adopting the finality directive of the European Commission would prevent an international conflict of laws and make it clear that the irrevocability and finality in designated Hungarian systems are ruled by Hungarian law and cannot be jeopardized by court decisions abroad in bankruptcy affairs.

80. Due to the present uncertain legal provision on pledges, the NBH, as lender of intra-day credit is exposed to credit risk. Risk management based on repos is not a viable alternative because the legal basis of this financial instrument remains uncertain. In the Treaty of Maastricht central banks in the EMU are obliged to cover all credit-transactions by taking adequate collateral. The present legal provisions on collateral taking are not in line with the European finality directive an issue that needs to be addressed in the run-up to EU. So far, the inadequate provisions on pledge have not influenced the willingness of the NBH to grant intra-day credit¹⁰.

81. The Giro Clearing House Ltd. is licensed by the NBH to provide interbank clearing services. The irrevocability and finality of the payments cleared in IGS is not threatened by a zero hour rule. The system does not make use of multilateral netting and so is not hampered by the deficiencies in the bankruptcy law.

82. All operating rules regarding VIBER are set out in bilateral contracts and a rule book. This includes membership criteria, responsibilities of the participants, collateral arrangements, etc. Participants in VIBER are not exposed to credit and counterparty risk.¹¹ Although liquidity risk could occur in an RTGS system, the probability of a gridlock in VIBER seems negligible. The daily value of all transactions relative to total available liquidity for all participants in the system is rather low and indicates that, on a collective level, there are no liquidity problems.

83. On an individual level, banks with a liquidity shortage during the day are supported in their liquidity management by an efficient queuing facility in VIBER. This facility allows for

¹⁰ The amended Act of the NBH (currently before parliament) provides that pledges and collateral granted to the NBH as part of its monetary policy operations will have a privileged status.

¹¹ The risks in VIBER are set out in a brochure available to every participant or applicant. The NBH has published an occasional paper on *Payment Systems and Monetary Operations*, in which it explores how real time gross settlement influences liquidity management.

priority setting and information on queued transactions. The NBH also schedules its own transaction in a way that benefits other participants. Finally, the VIBER system contains an algorithm that enables for circular processing in the event of a gridlock situation.

84. All rules, liabilities and responsibilities regarding IGS are laid down in uniform bilateral contracts. The general terms of this contract and possible alternations are published in the Official Gazette of the MoF. Participants in a deferred gross settlement system as the IGS are not exposed to credit and counterparty risk. IGS and VIBER complement each other. The IGS operates during the night when the VIBER system is closed. Banks send payment orders to IGS in batches. A batch will be processed for as long as the limits of these banks are not exceeded. The limits are composed of the available funds in the settlement account of a bank in VIBER at the end of the day, including the maximum amount the bank in question can draw under the intra-day credit line with the NBH. These limits are received from the NBH before the settlement process in IGS is started. As the total of all limits in VIBER is quite high, the liquidity risk in IGS is negligible. Incoming payments from other banks are continuously added to this available balance. The total of all payments of each bank to other banks is calculated (the clearing position matrix) and sent for settlement to the NBH. The NBH settles these positions before the opening of VIBER in the morning. Due to the check against available funds in the IGS, settlement in VIBER is always possible. From that moment onwards, all the underlying payments are irrevocable and final. If funds are insufficient, payments are queued and settled in a special second run during the day in VIBER. Special measures are taken to ensure that funds are available to settle the payments in the second run. However, if the bank cannot raise enough funds, the queued items are cancelled and must be re-entered for settlement the next day. Only in exceptional cases two processing cycles are run.

85. VIBER, in operation since the end of 1999, is similar to the RTGS systems used by the central banks of Luxembourg, Ireland, and by the European Central Bank. The system meets the security levels and other requirements set for the European TARGET system, which in many areas go beyond the CPSS core principles. Change request and testing procedures are in place.

86. The SWIFT network and standard messages types are used for communication between the NBH and the participants, providing for authentication, integrity and confidentiality. In emergency situations in which a bank has no access to the SWIFT network, procedures are in place to enter the transactions via a terminal located at the NBH (central contingency site for all participants). In the contingency plan of the NBH, arrangements and procedures are developed and documented to provide continuity of the service in case of other internal and external threats to the system. The NBH uses two servers, one for data communication and one for payment processing. If one of the servers goes down, immediately, the other server takes over its task (hot standby mode). At the time of the assessment (February 2000) there was no second processing site, but work is on its way to set up such a site in the near future.

87. IGS operates its own communication network with computer to computer links and dedicated telephone lines (two lines for every connection). Only authorized people can send batches through the network and their authorization is automatically checked by the system and recorded. Adequate measures have been taken to ensure authentication, integrity and confidentiality of the message flows and to prevent unauthorized access to the computers of the Clearing house. An operative and a hot back-up is available, as well as a remote site which can take over within one hour. The main and reserve operating center started operating in the third quarter of 1998 and technology is up to date. The London-based BVQI firm granted GIRO Ltd. the ISO 9002 certificate in November the same year.

88. From an operational point of view, the VIBER system is efficient and practical to its users. It offers possibilities for straight-through processing. The model 1 DVP settlement system, developed in close cooperation with KELER, the CSD in Hungary, services very well monetary policy operations and the OTC markets. Securities transaction can be settled within 7 to 45 seconds after the trade is matched. The pricing policy of the NBH is aimed at achieving full cost recovery. A flat-rate transaction fee is charged of Ft 1,200 (EUR 4.51).

89. IGS offers the possibility for straight through processing which is very important in Hungary, where, due to regulations of the NBH, the processing time of payments between two customers of different participants of the IGS is limited to two days. Tariffs in the IGS are more than cost effective and, compared to those for retail payments in the Euro zone, relatively high because IGS does not yet operate at full capacity.

90. Gross settlement of retail payments through IGS calls for large amounts of liquidity and could give rise to high funding costs, especially while banks have yet limited possibilities to influence the outcome of the clearing process and to prevent rejection of payment orders. Whether a batch is accepted or not, depends also on the order in which batches are sent in and the processing order within the IGS of batches of different banks. No optimization features are in place to minimize the amount of rejected payments and, thus, demands for high liquidity levels. However, this does not yet seem to confront banks with high opportunity costs as they can use their reserve requirements for this purpose. As reserve requirements are likely to go down in the future, intraday credit might become the principal source of liquidity and, in that situation, banks will be obliged to pledge large amounts of collateral. An alternative solution to this problem can be the reshaping of the participants' batching procedures by assorting more but smaller batches.

91. Processing in IGS is time constrained. The process cannot be started before VIBER is closed and has to be finished before VIBER opens. If in the run-up to the EMU, the opening time of VIBER will be brought in line with that of TARGET, this will narrow the processing window of IGS very substantially. Also extended openings time of VIBER, caused by problems elsewhere in Target, will lead to a further reduction of the IGS processing time in such occasions and might make the IGS vulnerable in the near future.

92. VIBER is open to all domestic credit institutions and branches of foreign banks. There is only one—technical—criterion for participation, namely having an established

SWIFT connection. Banks licensed to offer payment services to the public must join either VIBER or the IGS. There are no restrictions on participation in the system providing that certain technical requirements are met. The membership criteria are published and a well known auditing company should certify that the applicant meets the criteria.

93. Governance by the NBH is ensured. VIBER is owned, managed and operated by the central bank. The system is developed in close cooperation with the banking industry. Aiming at consensus, the NBH negotiates changes in general terms and conditions with the banking sector, represented by the Hungarian Banking Association. These terms and conditions are laid down in bilateral contracts. To ensure transparency the NBH applies uniform conditions to all participants. The NBH internal audit department plays an important role in the governance arrangement. In addition, separate entities are dealing with the actual operation of the system and the controlling of the adequacy of the risk- management policy of VIBER as well as the oversight of payment systems.

94. The Giro Clearing House Ltd, in charge of IGS, is subject to sound corporate governance. Representatives of the NBH and shareholding banks form the board of governors of the Clearing house Ltd. Bi-monthly consulting sessions with the users are organized, where possible problems are discussed and the demand for new services is assessed. However, all modifications and additions to the rules and the functioning of the clearing process require the approval of the NBH as an overseer of payment systems.

95. The Basel Core Principles for Systemically Important Payment Systems include four responsibilities for central banks regarding payment system oversight. The role of the NBH in the payments area is defined in the Constitution of the Republic of Hungary, in the NBH Act of 1991 and in the Banking Act of 1996. The NBH is authorized: (a) to regulate the circulation of payments; (b) to license financial institutions for the issuance of cashless payment instruments; (c) to oversee domestic payment systems; and (d) to provide settlement facilities. Within its scope of competency, the NBH is entitled to issue decrees with respect to payments and clearing matters. The NBH is also concerned with the stability of the financial system. There are no outstanding issues with respect to the NBH's responsibilities.

96. In the past, the NBH has discussed its objectives with the banking community within various ad-hoc interbank committees dedicated to the development of certain areas of payment systems, such as the setting up of IGS and VIBER or the introduction of new payment instruments. In March 2001, the NBH published a strategic memorandum (*Role of the NBH in ensuring the smooth functioning of payments systems, and in the regulation of money in circulation*) concerning the oversight role of the NBH and the explicit formulation of its objectives.

Main findings regarding the securities settlement systems

97. The Central Clearing House and Depository (Budapest) Ltd. (KELER) acts as the CSD and provides settlement services to the OTC market, the BSE spot market and the derivatives markets of the BSE and the BCE. KELER is the sole provider of inter-

institutional clearing and settlement services in Hungary and operates three settlement systems for securities. The RTGS-system settles trades in the OTC market and monetary policy operations of the NBH, the issuing of government papers and block trades on the BSE. For spot transactions on the BSE two multilateral-net settlement systems are used; one for government securities which has a rolling settlement cycle of two days (SC-T+2) and the other for all other listed securities with a settlement cycle of five days (SC-T+5). The project for shortening of the settlement cycle of other listed securities to T+3 is expected to be completed in 2001.

98. From an operational and organizational point of view, KELER broadly complies with the set of recommendations for securities settlement systems recently published by the joint CPSS-IOSCO task force. Issues to be addressed pertain to the legal basis for i) multilateral netting and ii) collateral arrangement used for risk-management, which is not sound and needs to be strengthened. The legislation supporting securities lending and borrowing is weak, or is lacking for some instruments. In particular, the validity of repo contracts should be recognized explicitly by Hungarian law.

Table 4. Hungary: Summary of Main Findings of Assessment of Observance of CPSS Core Principles for Payment Systems

Subject	Main Findings
Well-founded legal basis in all relevant jurisdictions (CP 1)	Legal basis for payment systems is fine. Due to the present uncertain legal provision on pledges, the NBH, as lender of intra-day credit is exposed to credit risk. The amended NBH Act will address this issue.
Understanding of the system's impact on risks; and procedures for the management of risks (CPs 2-3)	No actions required.
Final settlement; inability to settle by the participant with the largest single settlement obligations (CPs 4-5)	No actions required.
Assets for settlement (CP 6)	No actions required. Settlement takes place in central bank money.
Security and operational reliability; and contingency arrangements (CP 7)	No actions required. VIBER operates on similar technology as TARGET, which in some respects goes beyond CPSS principles requirements.
Practical for the markets and efficient for the economy (CP 8)	IGS is relatively costly. At the moment banks can use their required reserves, but in the future, as the latter go down, they will need to rely on intraday credit and provide the necessary collateral.
Objective and publicly disclosed criteria for participation (CP 9)	No actions required.
Governance of the system should be effective, transparent and accountable (CP 10)	Good governance is ensured. NBH oversees VIBER and the clearing house oversees IGS.
Responsibilities of the Central Bank in applying the Core Principles (CP 11)	Central bank complies with all responsibilities regarding oversight of the systems.

Authorities' response and recommended next steps

99. The authorities were in agreement with the assessment. They agreed that the legal basis for pledges and collateral needs to be strengthened, but were of the view that the risks involved in the current legislation are minimal for payment and settlement systems.

VI. REPORT ON THE OBSERVANCE OF STANDARDS AND CODES—TRANSPARENCY OF MONETARY AND FINANCIAL POLICIES

A. Monetary and Financial Policies (MFP) Transparency Code—Monetary Policy

General

100. The assessment of observance of good transparency practices in monetary and financial policies by the NBH, the HFSA, and the NDIF was carried out as part of the joint Bank-Fund FSAP.

101. The assessment was based on the *IMF Code of Good Practices on Transparency in Monetary and Financial Policies (the Code)*. No assessment methodology has been developed as yet, but the assessment has taken into account the implementation issues mentioned in the *Supporting Document to the Code*.

102. The detailed assessment was prepared by Bruce White (Reserve Bank of New Zealand). The assessment was based on a review of the legal framework and discussions with the Hungarian authorities, who cooperated fully with the assessment and provided all necessary clarification and documents.

Institutional and macroprudential setting, market structure—Overview

103. The NBH is the country's central bank. The Bank is established by Act LX of 1991 on the NBH, and amended in 1991, 1992, 1994, 1995, 1996 and 1997 (twice).¹² The HFSA is in charge of supervision of banking, capital markets, insurance and pension funds. The agency was established by the Act on the HFSA (1999). The NDIF is the country's deposit insurance agency, established in 1993 and 1996 brought under the Act on Credit Institutions and Financial Enterprises.

¹² In early 2001, the government submitted a new NBH Act to Parliament. This Act aims at being EU compatible. The draft Act would make price stability the NBH's main objective and setting monetary policy its primary task. Other major changes include (a) replacing the Central Bank Council by the Monetary Policy Council which would be an operational body, meeting twice a month and deciding on the course of monetary policy; (b) eliminating the Supervisory Board, and (c) giving oversight of the NBH's operations to the State Audit Office. Day-to-day management of the NBH would be the NBH Board of Director's responsibility. The authorities hope to implement this new Act in the course of 2001.

104. The high degree of observance of the Code on Transparency in Monetary and Financial Policies by the NBH, the HFSA and the NDIF underline Hungary's continuous efforts to be in the forefront on issues of transparency and standards. Compliance with requirements on clarity of roles, responsibilities and objectives of monetary policy is complete, as described in the NBH Act. When it comes to the openness of the formulation and reporting of monetary policy decisions, compliance is broadly complete. Indeed, the NBH announces and explains objectives, targets and instrument setting typically through several periodic publications. Press releases are used to announce changes in the setting of instruments. However, the text of these releases is short and as a rule do not explain the reasons for policy changes. Also, meetings of the NBH's council—its primary monetary policy decision-making body—are not announced in advance and there is no predetermined number of meetings per year. Public information services are well organized and very accessible and, thus, compliance is high. The NBH meets all criteria in terms of accountability and assurances of integrity. In terms of its financial policies, more clarity is desirable with respect to the NBH's oversight role in the payments system. The HFSA's policies are also highly transparent, and have been improving since its inception in April 2000, with the planned publication of a mission statement, the extension of its announcements on the website, and planned interactions with the press on recent policies. Shortcomings relate to the ambiguity with respect to the accountability of its president, and the publication of its balance sheet, which is part of the government budget. The NDIF's policies and operations are fully observant of the principles laid down in the code.

Main findings

105. The central bank is the NBH, responsible for the formulation and conduct of monetary policy. The ultimate objectives of the NBH are specified in the preamble to the NBH Act: "To strengthen the stability of the Hungarian currency; the operation of the domestic payments system; and the internal and external financial equilibrium of the economy, its lasting development and financial integration." The NBH Act stipulates that the basic task of the NBH is to safeguard domestic and external purchasing power of the national currency.

106. The governing bodies of the NBH are established by the NBH Act. The NBH is directed by a President and at most five Deputy Presidents. The president and deputy presidents of the NBH are appointed by the president of the Republic, on the proposal of the prime minister, for terms of six years. Criteria for appointment, and discharge from office, of the president of NBH and the Deputy Presidents are contained in the NBH Act. The Act also stipulates that the president of the NBH is under obligation to report to the parliament. In practice this obligation is discharged through (a) submitting annual monetary guidelines to the parliament, and by appearing before the relevant committee of parliament to be examined on those guidelines; (b) submitting an annual report to parliament, and by appearing before the relevant committee of parliament to be examined on that report; and (c) appearing before the committee of parliament on other matters as required.

107. The **central bank council** is the highest monetary policy organ of the NBH and comprises the president of the NBH (as chair), the deputy presidents of the NBH, and members (who can be external to the NBH) of a number equal to the number of deputy presidents plus one. The members are appointed by the president of the Republic, on the proposal of the prime minister upon consultation with the president of NBH, for terms of three years. Criteria for their appointment are prescribed in the NBH Act and the criteria governing their removal from office are the same as those applied to the president of the NBH.

108. The **board of directors** supports the president of the NBH in implementing the tasks devolved to him. (In effect, it is the executive committee.) It comprises the president and deputy presidents of the NBH, and such other employees of NBH elected by the General Meeting upon consultation with the president of NBH. Terms of office or criteria for appointment to and discharge from office (beyond those that already attach to the positions of president and deputy president) are not prescribed.

109. The **supervisory committee** is the supervising organ of the NBH. It comprises the chairman (elected by the parliament), three representatives elected by parliament, a representative of the minister of finance and an expert invited by the minister of finance. The members of the supervisory board are appointed for terms corresponding with that of parliament, and may be recalled by the parliament electing them or the minister of finance appointing them.

110. The NBH's autonomy in monetary policy is also guaranteed by the stipulation in the NBH Act that the government has no authority to override central bank policy decisions conferred on it under the Act. The exchange rate policy is the subject of mutual agreement between the government and the NBH. The Act provides that "the government takes a stand regarding the annual guidelines of monetary policy of the NBH before they are presented to the parliament," but there is no obligation for the NBH to change its stance accordingly. The Act also provides that the NBH is authorized—if it cannot assert its standpoint in any other way—to make public its opinion about economic policy decisions of the government and the ministries and the legal regulations issued by them.

111. The NBH Act is also transparent on the issue of central bank credit to the government stipulating that the NBH may not grant credits to the government. Until the end of 2000, one facility existed, the so-called liquidity loan for bridging temporary liquidity difficulties (up to 2 percent of the planned budget revenue of the actual year and a maximum of up to 15 days in a calendar month). This facility was eliminated in January 1, 2001.

112. The NBH Act is clear on the roles played by the central bank (a) in the management of domestic and external public debt and foreign exchange reserves; (b) as banker to the government; (c) as fiscal agent of the government; and d) as advisor on economic and financial policies and in the field of international cooperation.

113. The framework, instruments, and targets of monetary policy are disclosed and explained in a number of legal documents and NBH publications. First, the NBH Act prescribes the objectives of monetary policy in terms of, *inter alia*, “stability of the Hungarian currency” and “the internal and external financial equilibrium of the national economy.” Also, the NBH Act defines that the NBH conducts monetary policy through refinancing; regulating the reserve and liquidity requirements of credit institutions; influencing or determining exchange rates and interest rates; and open market operations and other instruments of monetary control.

114. Several publications describe and analyze on an ongoing basis how the NBH pursues the objective, and uses the instruments, established by the NBH Act. The **Monetary Policy Guidelines** have been used by the NBH as a document for elaborating the macroeconomic context within which it is envisaged that monetary policy will be conducted during the year ahead, including with respect to assumptions on key exogenous variables. The **Quarterly Inflation Report** provides a comprehensive quarterly review of macroeconomic developments, with a particular focus on developments in monetary conditions and inflation. These publications provide the reader with a good understanding of the framework within which monetary policy is conducted in Hungary. They are available on the NBH’s extensive webpage.

115. The **central bank council** is the policy-making body and decides on the annual monetary policy guidelines of the NBH; on the view of the central bank on the exchange rate policy; and on the major amendments of the central bank policy instruments, exceeding the limits of the accepted monetary policy inclusive of the exchange rate policy. The *president* of the NBH is responsible for the implementation of the decisions of the central bank council. The board of directors supports the president of the NBH in implementing the tasks devolved upon him. In addition, there is also the **internal monetary policy committee** which meets regularly (normally weekly) to review monetary policy developments and to advise the president of the NBH. Its operation is regulated by an internal regulation. This committee is advisory in nature, with no formal powers.

116. Changes to the setting of policy instruments—most typically changes to the two-week deposit facility rate—are announced immediately after the tender has taken place. Announcement is by way of press notice—normally with a brief (a few sentences) explanation of the reason for the change. More substantive discussions of the considerations surrounding policy instrument adjustments follow in the next **Quarterly Inflation Report**. (Dates for the publication are not pre-announced, but there is an implied commitment to publish quarterly.) The NBH periodically presents its monetary policy objectives to the public, with the supporting rationale, targets and key underlying assumptions, in its annual Monetary Policy Guidelines and Quarterly Inflation Report. A complete overview is presented in the Annual Report.

117. The NBH publishes its balance sheet at monthly intervals, in its Monthly Report. Data on (gross) market transactions of the NBH are not disclosed, but data on gross transactions of the two main policy instruments of the NBH (the 2-week deposit facility and

the 3-month NBH bond) are published on Reuters without delay. Detailed information is given on credit institutions' net month end balances, and on the interest rates that are associated with various facilities. Information on the amounts and terms of refinance outstanding at month-end under its refinance facilities, and on funds held in its deposit facilities, is disclosed monthly in the NBH's Monthly Report.

118. The NBH's practice, when it has provided emergency financial support (in terms of the emergency financial support facility established by Article 17 of the NBH Act), has been to announce the details shortly after the event. Such support in recent years has been provided in the context of interventions by supervisory agencies to stabilize the institutions in question.

119. The NBH has a comprehensive publications program, including an Annual Report, a Monthly Report, Monetary Policy Guidelines, Quarterly Inflation Report, the Report on Financial Stability, Occasional Papers, and other background publications on the NBH. All of these publications are available on the Bank's website, many of them also in English. The NBH also has a public information office, responsible for the NBH's publications, for the management of monetary policy announcements, and for relations with the media.

120. Accountability of the president has been assured. The president of the NBH appears before the parliament generally two times a year, to be examined, respectively, on the *Monetary Policy Guidelines*, and the *Annual Report*. He may additionally be called to be examined on other matters at any time. The NBH's financial statements are audited by an external accounting firm (currently PriceWaterhouseCoopers) and the audit certificate is published along with the financial statements. The financial statements included in the *Annual Report* are summarized, while more comprehensive financial statements are contained in the Annual Report that is submitted to parliament.

121. Transparency is provided in the NBH Act with respect to provisions relating to the obligations of NBH officials and employees to avoid conflicts of interest. The different obligations of senior officials (including members of the central bank council) are spelled out, as are those of NBH employees. The potential conflicts of interest addressed include those arising from political affiliations, and relationships with credit institutions (and the NDIF). The obligations of NBH officials and staff in relation to conflicts of interest include certain notification responsibilities where close relatives have interests that come within the ambit of those mentioned in the Act. Because under the Hungarian legal system, liability does not extend to the staff of official bodies, protection from legal liability is not considered necessary. However, staff may be subject to disciplinary action for negligence (including termination of employment), under the employment law.

122. There is no public elaboration of the role of an internal audit, but Article 70/A of the NBH Act provides that the auditor of NBH may not be re-elected. The auditor has maximum term of five years, to ensure his independence.

Table 5. Hungary: Summary of Main Findings of Assessment of Observance of MFP
Transparency Code—Monetary Policy

Subject	Main Findings
I. Clarity of roles, responsibilities and objectives of central banks for monetary policy.	No actions required.
II. Open process for formulating and reporting monetary policy decisions.	NBH has an open process for formulating and reporting policies. Improvements could be made if meetings of the central bank council were announced in advance, and a clear calendar of council meetings or a predetermined number of meetings per year were announced. Given the current policy framework (exchange rate band) this deficiency is not a particular problem, but improvements might be considered. (This is envisaged in the new Act). There are also as yet no clear standards for reporting by the council and the operations of the Board are not subject to transparent rules.
III. Public availability of information on monetary policy.	No major actions required. Publishing the NBH's balance sheet and additional information on the central bank's monetary operations would further improve the NBH's transparency practices.
IV. Accountability and assurance of integrity by the central bank.	No major actions required.

Authorities' response and recommended next steps

123. The Hungarian authorities were in broad agreement with this assessment.

B. MFP Transparency Code—Hungarian Financial Supervisory Authority

Main findings

124. The broad objective of the banking supervisory authority is publicly disclosed in the Act of 1999 on the HFSA. Broadly, the functions are ensuring the stability and efficient operations of the Hungarian financial market; protection of the interests of the clients of financial institutions; and ensuring the transparency of the market and promoting fair and lawful competition. The authority of the HFSA with respect to licensing, supervision and taking measures is quite clear, as well as the prudential rules and regulations it applies when supervising the financial sector. The accountability remains ambiguous, but work is underway to clarify. While, according to the Act of 1999, the Chairman will be appointed by Parliament on the advice of prime minister, the institution continues to be under the supervision of the MoF. In 2000, the HFSA published a mission statement to clarify its objectives, responsibilities and working methods.

125. The HFSA is governed by a Chairman and one deputy Chairman and the details of appointment are published in the government gazette. The term of appointment is for six years. Candidates for the post of Chairman or his deputy shall have an appropriate degree in

higher education in addition to no less than five years experience in management of financial or business affairs at any financial or capital market organization or public administration. The appointment can be terminated by dismissal upon conviction of a criminal offence, failure to terminate any conflict of interest with such position, permanent inability to attend to his duties, and upon endangering the operations of the Commission by his activities.

126. On matters of cooperation between the HFSA, the NBH, the NDIF and other agencies, the Act is clear. The legislation sets out the circumstances, that require consultation or prior approval of other financial agencies by HFSA. Such circumstances include the granting of licenses to perform financial services in foreign currency and foreign exchange and certain other financial services (consultation between the HFSA and the NBH); revocation of a credit institution's license (needs approval of MoF and the President of the NBH); and when measures or exceptional measures are taken and fines imposed on the financial institution (needs to inform the NBH). The HFSA has also entered into cooperation agreements/MoUs with the NBH and the NDIF. The agreement between the HFSA and the NDIF will be posted on the website of both institutions in the near future. The agreement between the NBH and the HFSA is not disclosed. One such agreement provides for exchange of recurring prudential information. As regards sharing information with various other supervisors the HFSA does, for the moment, not have formal arrangements or information sharing agreements with foreign banking supervisory authorities although a number of MoUs are under preparation.

127. The HFSA published its first annual report at the end of 2000 on how its overall policy objectives are being pursued. There are plans to restructure the report to provide more information on the supervisory role. There is a presumption in favor of public consultations in the process of (re)formulating financial regulations. The consultation period is more than three months. The new regulations take effect more than three months after the end of the public consultation process. Financial regulations are issued as government/ministerial decrees. Any technical changes involve amendments to these decrees. The professional associations of market participants are consulted through meetings and written comments are also welcome.

128. The HFSA maintains a public information service whose function it is to disseminate policy decisions and policy announcements. The agency also has a website, which contains the information listed above as well as the annual report, related legal instruments, list of banks, broker houses and other registered market participants. Plans exist for the President to meet with the press as and when specific issues arise. The HFSA is also planning to open an office where the public at large can make inquiries about the supervisory process and the supervised institutions.

129. The HFSA does not publicly disclose its audited financial statements. It is audited by the State Audit Office. The HFSA functions under the supervision of the MoF. Its accounts are, therefore, part of the budget and to that extent there would be some disclosure through the budget. In addition, its president is not required to appear before a designated public authority.

130. In line with the situation for the NBH staff, the Banking Act and the Act on the HFSA do not provide legal protection directly to the HFSA staff. However, there is legal protection for the president and all the decisions made by HFSA are the responsibility of its president. The law on civil servants and the law on public administration procedure prevent that supervisors can be sued because of their professional work.

131. The HFSA has publicly disclosed policies on the conduct of financial affairs by its staff. The Act on the HFSA prohibits acquisition of shares in financial and capital market organizations, purchase of shares and so on. There are provisions in the ACIFE on conflicts of interest, prohibition of transactions connected with insider information and internal loans.

Table 6. Hungary: Summary of Main Findings of Assessment of Observance of MFP Transparency Code—Financial Sector Supervision

Subject	Main Findings
V. Clarity of roles, responsibilities and objectives of banking supervisory agencies.	Responsibilities and objectives are well defined and transparent. Progress needs to be made regarding the accountability of the president.
VI. Open process for formulating and reporting of banking supervisory policies.	HFSA strives for the highest degree of transparency in its operations and procedures.
VII. Public availability of information on banking supervisory policies.	Contacts with press, professional organizations and through its website are encouraged by HFSA management.
VIII. Accountability and assurance of integrity by banking supervisory agencies.	See above. The accountability issue of the president is under review. Policies on the conduct of financial affairs by staff are disclosed. Budget is not disclosed as it is part of the state budget.

Authorities' response and recommended next steps

132. The authorities agreed with the assessment and underlined their policies aiming at the highest degree of transparency.

C. MFP Transparency Code—Payment Systems Oversight

Main findings

133. The objective of the NBH's role in the oversight of payment and settlement systems is contained in the preamble to the NBH Act and in a strategic memorandum, published in March 2001. The objective is to “strengthen the operation of the domestic payments system.” This objective is further specified in the Act: “the NBH establishes the payment and

settlement systems and is responsible for the regulation of the circulation of money.” Additional rules and the relevant licensing powers are also contained in the NBH Act.

134. Three payment and settlement systems operate in Hungary and their operation is documented by the NBH in two background publications.¹³ These publications outline the nature of the systems and provide some high level information on their risk features, e.g., deferred net settlement or real-time gross settlement. However, they do not include detailed discussion of the robustness of these systems to risk—such as might be provided within the framework of the Lamfalussy standards for payment systems, or the CPSS core principles for systemically important payment systems. The risk management standards that the NBH seeks in payment and settlement systems have not been promulgated.

135. Work is underway in the NBH to better define the central bank’s role in the payments area in line with the CPSS Core principles. The NBH has oversight responsibility for clearing, payment and settlement systems, but this role is performed mainly in the NBH’s capacity as a co-owner of the relevant systems, rather than as overseer of a self regulatory organization. This situation also helps explain why detailed risk management principles for Hungary’s systemically important payments and settlement systems have not (yet) been promulgated.

Table 7. Hungary: Summary of Main Findings of Assessment of Observance of MFP Transparency Code—Payment Systems Oversight

Subject	Main Findings
V. Clarity of roles, responsibilities and objectives of payment systems oversight agencies	Objectives are clearly specified in NBH Act.
VI. Open process for formulating and reporting of payment systems oversight policies	Is done through publications. Risk management standards could also be promulgated.
VII. Public availability of information on payment systems oversight policies	Done through publications.
VIII. Accountability and assurance of integrity by payment systems oversight agencies	Done through publications.

Authorities' response and recommended next steps

136. The authorities are in broad agreement and are working on a better definition of the NBH’s role and responsibility in payment and settlement systems.

¹³ An occasional paper on *Payment Systems and Monetary Operations*, and an explanatory booklet on the VIBER real-time gross settlement system.

D. MFP Transparency Code—National Deposit Insurance Fund

Main findings

137. The NDIF was established in 1993 and in 1996 brought under the Banking Act. When the fund was initially set up in 1993 there was a massive advertising campaign to communicate the goals and objectives of the fund to the public. The duties of the fund are specified in the legislation and, hence, publicly disclosed. The Deposit Insurance Guide, which is widely circulated among the public, explains the objectives of the fund. Its duties are disclosed in the Act: (a) to indemnify the depositors on deposits insured by the fund to the extent protection is available when the deposits are frozen, or in the event of initiation of liquidation proceedings; and (b) incur commitments as specified in the Act in order to prevent the deposits from being frozen in consultation with supervision. Section 104 of the ACIFE specifies the measures that the fund may take to prevent the deposits from being frozen. The fund is obliged to select the solution resulting in the least long-term cost.

138. Formulation of NDIF policies is mainly limited to the setting of the level of the premiums. In this regard the NDIF's policies are transparent. The NDIF publishes an Annual Report which contains its strategic goals, information on its premium policies, and on the fund's participation in crisis management/litigation. This information is also published on its website..

139. Open public information is also available on the NDIF's interventions. When emergency financial support is granted by the fund it is disclosed either within three months or between three and six months. The information is given through public releases, in media and also published in the annual report. Information on the nature and form of client asset protection, operating procedures, financing and the performance of the client asset protection arrangements are publicly disclosed in the Annual Report, deposit insurance guide, public release and voice mail services.

140. An independent auditor audits the accounts of the NDIF. It is a private sector firm appointed by the board. Information on accounting policies and any qualification form an integral part of the publicly disclosed financial statements. The Banking Act appoints the State Audit Office to examine the finances and accounting of NDIF. The first examination was made in 1995; the second is still proceeding. The report on the first examination was sent to Parliament and to the member institutions. The NDIF has publicly-disclosed policies on the conduct of financial affairs by its staff.

Table 8. Hungary: Summary of Main Findings of Assessment of Observance of MFP
Transparency Code—Deposit Insurance

Subject	Main Findings
V. Clarity of roles, responsibilities and objectives of deposit insurance agencies.	Responsibilities and objectives are clearly spelled out.
VI. Open process for formulating and reporting of deposit insurance policies.	NDIF has open policies of formulating and reporting policies.
VII. Public availability of information on deposit insurance policies.	Through brochures, website and other publications.
VIII. Accountability and assurance of integrity by deposit insurance agencies.	Independent auditors audit accounts. Policies on the conduct of financial affairs by staff are disclosed.

Authorities' response and recommended next steps

141. The authorities agreed with the assessment and emphasized their drive for the highest degree of transparency.