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Hungary: Financial System Stability Assessment Follow-up, including Reports on the Observance of Standards and Codes on the following topics: Monetary and Financial Policy Transparency, Banking Supervision, Securities Regulation, Insurance Regulation, and Payment Systems

This Financial System Stability Assessment Follow-up paper on **Hungary** was prepared by a staff team of the International Monetary Fund as background documentation for the periodic consultation with the member country. It is based on the information available at the time it was completed on **May 3, 2002.** The views expressed in this document are those of the staff team and do not necessarily reflect the views of the government of **Hungary** or the Executive Board of the IMF.

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Financial System Stability Assessment Follow-Up

Prepared by the Monetary and Exchange Affairs and European I Departments

Approved by Stefan Ingves and Susan Schadler

May 3, 2002

This Financial System Stability Assessment (FSSA) was a follow-up on the work of the joint IMF-World Bank Financial Sector Assessment Program (FSAP), undertaken in 2000. During this follow-up staff met with senior management and staff of the National Bank of Hungary (NBH), the ministry of finance (MoF), the Hungarian Financial Supervisory Authority (HFSA), the National Deposit Insurance Fund (NDIF), as well as representatives of the financial sector. Staff cooperated closely with the Article IV consultation mission, headed by Mr. R. Feldman.

The team was led by Marc Quintyn (MAE) and comprised Margaret Cotter (LEG), Fernand Naert (Belgian Commission for Banking and Finance), Martin Overbeek, and Peter van den Broeke (both Pension and Insurance Supervisory Authority, the Netherlands). Roger Nord (IMF Regional Resident Representative) attended some of the meetings.

Hungary is in the final stages of transition to a market economy and has one of the most developed and diversified financial systems in Central and Eastern Europe. The banking system is well-managed and capitalized and the quality of its assets is high. The other sectors (insurance, pension funds, and investment service providers (ISPs)) are broadening their market shares from a low base. Overall, staff concluded that no major threats to systemic financial stability were apparent.

Three main sets of developments in 2001 are expected to enhance the financial sector's stability in the medium term:

- The substantial changes to the policy framework—widening of the exchange rate band, abandoning the crawling peg, adopting inflation targeting, and removing the remaining capital account restrictions—are stimulating the development of forint and foreign exchange markets. This adds stability to the system by providing resort to deeper markets that give the opportunity to hedge risks more efficiently.
- The significant changes to the legal framework—new acts on the NBH, credit institutions, capital markets, amendments to the insurance act, and a new Anti-Money Laundering Act—are building in additional safeguards to the system's soundness. In particular the adoption of the principle of consolidated supervision is a much needed improvement. The new anti-money laundering framework effectively addresses the June 2001 FATF concerns.
- The consolidation that is taking place among the credit cooperatives, the pension funds and the ISPs is also likely to enhance the medium-term stability of the system by eliminating the weaker institutions.

Staff encouraged the authorities to continue closely monitoring the risks in the system and to use the momentum offered by the run-up to EU accession to further address the remaining weaknesses in some areas of the legal and regulatory framework.

Section I of this report presents the main findings and overall assessment. Section II presents summary assessments of the observance of financial sector standards and codes.

The author of this report is Marc Quintyn (MAE).

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Glossary

AML/CFT	Anti-Money Laundering/Combating Financing of Terrorism
BCE	Budapest Commodities Exchange
BCP	Basel Core Principles for Effective Banking Supervision
BSE	Budapest Stock Exchange
CEE	Central and Eastern Europe
CPSIPS	Core Principles for Systematically Important Payment Systems
CSD	Central Securities Depository
DVP	Delivery-versus-payment
ECB	European Central Bank
EU	European Union
FAFT	Financial Action Task Force
FSAP	Financial Sector Assessment Program
FSSA	Financial System Stability Assessment
HFSA	Hungarian Financial Supervisory Authority
IAIS	International Association of Insurance Supervisors
IAS	International Accounting Standards
IGS	Interbank Giro System
IOSCO	International Organization of Securities Commissions
ISP	Investment service provider
MC	Monetary Council
MoF	Ministry of finance
MoU	Memorandum of Understanding
MPC Code	Code of Good Practices on Transparency in Monetary and Financial Policies
NBFI	Nonbank financial institution
NBH	National Bank of Hungary
NDIF	National Deposit Insurance Fund
OTC	Over-the-counter
SRO	Self Regulatory Organization

Section I—Staff Report on Financial Sector Issues

I. Executive Summary and Overall Stability Assessment

1. **Hungary, which is in the final stages of transition to a market economy, has one of the most developed financial systems in Central and Eastern Europe (CEE).** The financial sector contains a broad set of institutions, and sound macroeconomic policies have facilitated the development of financial markets and instruments. Through well-targeted policies in the earlier transition years, the authorities succeeded in attracting reputable foreign strategic investors in all segments of the financial system. This strategy is paying off in terms of sector stability.

2. **Staff concluded that no major threats to systemic financial stability were apparent.** The banking system remains well capitalized, and the quality of its asset portfolio has not been significantly affected by the economic slowdown in 2001. The other segments of the financial system—ISPs, insurance companies, and pension funds—continue their steady growth and are increasing their market shares. The dominance in the financial markets of large financial groups continues to intensify. This, together with the dominance of foreign strategic investors, are two of the salient features of Hungary's financial system.

3. **Against the background of an international economic slowdown and turbulence in other emerging market economies in 2001, the Hungarian financial system continued to show its resilience.** In addition to this general observation, three more specific observations stand out with respect to the developments in 2001. Their combined effect amounts to a further strengthening of the financial system by removing some of the weaker areas identified in the course of the 2000 FSAP/FSSA effort:

- The combination of the changes in the monetary policy framework in 2001—widening the exchange rate band, abandoning the crawling peg, adopting inflation targeting, and removing the remaining capital controls—**is facilitating and stimulating the development of forint and foreign exchange money markets.** Deeper and more diversified money markets add to the stability and the resilience of the financial system. The legal initiatives that have taken away the uncertainty regarding the status of repos and pledges reinforce these trends.

- The strengthening of the legal and regulatory framework **serves as an additional safeguard for the system's stability in the medium term.** The new decision-making process of the NBH, as stipulated in the new Act, in combination with the adoption of inflation targeting, adds to the transparency of monetary policy. The new Credit Institutions Act sets the stage, among other improvements, for consolidated reporting and supervision—a much needed improvement. The new Capital Markets Act strengthens the supervisors' enforcement powers, and further liberalizes the markets. Finally, the autonomy as well as the accountability arrangements of the HFSA have been enhanced. The strengthening of the legal framework with respect to anti-money

laundering/combating financing terrorism (AML/CFT) will indirectly contribute to the system's stability through improved governance practices.

- Finally, the **consolidation** that is taking place in the sectors of credit cooperatives, ISPs, and particularly pension funds will also contribute to the medium-term stability of the financial system by weeding out the smaller—and often loss-making—institutions.

4. **Nonetheless, market developments should be carefully monitored and evaluated with an eye to a few potentially vulnerable areas**. The concentration of bank credit to a handful of large borrowers, the fast growth of the mortgage loan market, and some lingering reluctance by the corporate sector to hedge against foreign exchange risks need due attention. The authorities are well aware of these vulnerabilities and watch them closely—most notably through the NBH's high quality semi-annual *Report on Financial Stability* and the HFSA's on-site inspections.

5. **The above mentioned improvements in the legal and regulatory framework for the financial system are reflected in the staff's assessments of compliance with financial sector standards and codes.** The updated summary assessments all show a high degree of compliance with international standards and best practices:[1]

- With the enactment of the 2001 Credit Institutions Act, compliance with the Basel Core Principles for Effective Banking Supervision (BCP) has further improved. In particular the introduction of consolidated reporting and supervision is an additional safeguard for preserving the soundness of the system. However, the Act did not address the lack of legal backing for the supervisors to enforce good governance in financial institutions; nor the absence of a gradual ladder of sanctions to address noncomplying financial institutions.

- The new Capital Market Act complies with most of the International Organization of Securities Commissions' Objectives and Principles (IOSCO). The Act has significantly strengthened the enforcement powers of the supervisors. The Act provides more sanctioning powers to the self-regulatory organizations (SROs). This, in and of itself, is useful, but calls for coordination between the HFSA and the SROs. Without such coordination the credibility of the supervisors could be undermined.

- The review of compliance with the International Association of Insurance Supervisors' principles (IAIS) indicates that the amendments adopted in 2001 established internal controls for derivative positions. However, the fit and proper testing should be broadened, legal backing for supervisors to instill good governance

[1] See Section II of this document for details.

principles strengthened, and supervision should continue to move away from a checklist-driven approach towards a risks-based approach.

- Following the adoption of the new Act on the NBH and clarifications published by the NBH with respect to its oversight role, compliance with the Core Principles for Systemically Important Payment Systems (CPSIPS) is complete. The adoption of the European Union (EU) settlement finality directive, planned for 2002, will introduce the principle of multilateral netting in Hungary. Its absence could potentially have hampered the smooth functioning of systems based on netting.

- Observance of the good transparency principles of the IMF's Code of Good Practices on Transparency in Monetary and Financial Policies (MPC Code) is nearly complete following the adoption of the new NBH Act. In particular, the operation of the Monetary Council (MC), in conjunction with the inflation targeting framework has increased the transparency of the monetary policy decision making process. The amendments to the Act on the HFSA also enhanced the transparency of the agency's accountability arrangements.

- The detailed assessment of Hungary's anti-money laundering mechanisms, including legal and institutional arrangements, using the Fund's (preliminary) expanded AML/CFT methodology indicates that the deficiencies noted by the Financial Action Task Force (FATF) in June 2001 have been effectively addressed. A timeframe for the elimination of anonymous deposits has been promulgated and the identification of beneficial owners improved. The new framework also broadens the range of institutions covered by the legal framework and establishes, through the HFSA, an adequate system of supervision of anti-money laundering mechanisms in the financial sector.

6. **The authorities are encouraged to use the momentum offered by the run-up to EU accession to further address the remaining weaker areas in the legal and regulatory framework.** For the insurance sector, the planned new law intends to address most of the issues raised under the assessment of compliance with the IAIS principles. For other sectors, however, no initiatives are currently planned. In addition to the sector-specific issues, the revision of the Bankruptcy Act should be expedited too.

II. Financial System Overview

A. Structure

7. **Hungary has one of the most advanced and sound financial systems among the CEE countries.** From the onset of the transition, the country has always been at the forefront of financial sector reform. Modernization progressed through three rounds of government-led bank restructuring. The last one, covering 1993–96 was the most far-reaching, putting strict conditions on bank management and recapitalization, and setting out a strategy to sell state-owned banks to strong strategic foreign investors.

8. **As a result of these efforts, the system now contains a broad set of institutions, markets, and instruments.** The main features of the Hungarian financial markets are limited government ownership; dominance of foreign ownership and of large financial groups; high degree of concentration; increasing competition; and still a relatively low degree of financial intermediation.

- **At end-2001 the Hungarian financial system was composed of** 41 commercial and specialized banks, 7 credit cooperatives, 187 saving cooperatives, 38 ISPs, 24 insurance companies, 38 insurance associations, 24 private pension funds, and 99 voluntary pension funds (Table 1).

- **Government ownership in all sectors has been reduced significantly and only remains substantial in the banking sector** (Table 2). In this sector, the government still owns 25 percent of registered capital through minority stakes.[2] Plans exist to further divest some of these stakes, although some backtracking has occurred. Government ownership in the insurance sector—a state monopoly at the end of the 1980s—has become insignificant.

- **The financial system is dominated by foreign ownership.** Strategic foreign investors own nearly two thirds of the banking system, 90 percent of the insurance sector and 70 percent of the ISPs.[3, 4]

- **An important feature of Hungary's new financial landscape is the increasing dominance of large financial groups.** At the end of 2001, 20 bank-led and 5 insurance-led groups controlled about 90 percent of the system's total assets.

- **Concentration remains high across sectors.** In the banking system concentration is particularly high in the retail segments, where 1 bank has over 40 percent of the household deposits, and the largest 5 banks account for over 70 percent of bank liabilities to households. In the life insurance sector, 5 institutions manage over 80 percent of the premiums.

- **Competition is intensifying despite the high degree of concentration.** In the banking system, competition in the corporate sector is intense, as judged from the narrowing margins, and competition is intensifying in the retail segments.

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[2] The increase in the government's share in 2001 is the result of a capital increase in one state-owned bank.

[3] The decrease in foreign ownership in 2001 in the banking system is due to the merger of two foreign-owned banks.

[4] Thus far, two Hungarian banks have established subsidiaries in neighboring countries.

Competition is growing in the insurance sector. Among pension funds, competition is also increasing, pushing the least efficient funds into mergers, or out of the market.

- **Domestic financial intermediation remains low, but is growing.** Bank claims on the private sector amounted to 30 percent of GDP at the end of 2000, while the ratio of M2 over GDP was close to 40 percent.

B. Regulatory and Supervisory Framework

9. **Responsibility for the supervision of the financial system rests with the HFSA.** The HFSA was established on April 1, 2000 by a merger of the previous sectoral supervisors (banking and capital markets, pension funds and insurance companies). The responsibility for the legal framework governing the financial sector resides with the MoF, under the oversight of the government. Hungary's legal system does not provide the HFSA with the right to issue binding rules and regulations. The HFSA's autonomy in granting and withdrawing licenses is complete for nonbank financial institutions (NBFIs). For commercial banks, the agency needs the NBH's consent for granting a license and of the NBH and the MoF for withdrawing a license.

III. Macroeconomic Environment and Risks

A. Macroeconomic Environment

10. **Hungary is successfully approaching the end of the transition to a market economy.** In particular during the five years ending in 2000, the country achieved and maintained strong output growth. Real per capita GDP increased by an annual average of 5 percent. Macroeconomic management was prudent, leading to lower inflation, a smaller fiscal deficit and a lower current account deficit. These policies, in combination with significant structural reforms, created a smooth environment for the development of an increasingly resilient financial system.

11. **Against the backdrop of an international economic slowdown, Hungary's economy performed well in 2001.** Although economic growth slowed, the economy showed considerable resilience to the weaker economic performance in the EU, with estimated real GDP growth still at 3.8 percent. While export growth decelerated, domestic demand was stimulated by buoyant private consumption in the face of strong real wage gains. As fiscal policy turned expansionary in 2001, the burden of lowering inflation was on monetary policy, aided by favorable exogenous developments (drops in oil and food prices). Year-on-year headline inflation fell from its peak of 10.8 percent in May 2001 to 5.9 percent in March 2002, owing in part to the appreciation of the forint in the wake of the widening of the exchange rate band.

12. **Reflecting these developments, selected macroprudential indicators do not show any major problems.** The current account deficit has narrowed (Table 3a). Hungary's external liquidity and short-term debt position are in a manageable range. External financing remained unaffected by the tensions in emerging markets in the course of 2001. The cover

provided by international reserves for short-term external debt remained at a comfortable level in 2001. The growth in bank credit to the private sector slowed down in 2001, mainly because of lower demand by the corporate sector. The growth in bank credit to the household sector continued to accelerate, driven by a high demand for mortgage loans.

13. **Financial soundness indicators for commercial banks also remain reassuring** (Table 3b).[5] The commercial banks' risk weighted capital adequacy ratio remained virtually unchanged—also indicating the strong commitment of foreign owners to their strategic investments in Hungary. The quality of bank assets remains high, despite the economic slowdown and provisioning (not reported in the table) is adequate. Profitability as measured by the ROA and ROE improved significantly in the course of 2001, partly because of one-off effects.[6]

14. **Against the backdrop of this positive outlook, discussions with the authorities focused on two main areas.** First, the impact of the new monetary policy framework on the operations of the banking system. Second, going forward, potential external and domestic risk factors for the financial sector's soundness.

B. The New Policy Framework and Impact

15. **One of the key characteristics of 2001 was the changeover to a new monetary policy framework in Hungary.** In May 2001, the authorities widened the exchange rate band from +/-2½ percent to +/-15 percent around a central parity defined against the euro. In June of 2001, the authorities adopted an inflation targeting framework—the monetary policy instruments used remained unchanged. The (few) remaining restrictions on capital movements were also lifted in June. Finally, the crawling peg was abandoned in October.

16. **The inflation targeting framework, in conjunction with the provisions in the new NBH Act with respect to the NBH's primary objective—price stability—and the operation of the MC, have enhanced the transparency of monetary policy operations.** The operation and implementation of the inflation targeting framework is described in detail in the NBH's *Quarterly Inflation Report*, the central bank's leading monetary policy publication (Box 1). This report provides an extensive review of monetary conditions and inflation developments as well as a forward looking analysis, setting out the elements that

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[5] The financial soundness indicators reported here only apply to commercial banks. The authorities are preparing reporting on a consolidated basis for large financial groups.

[6] Profits from the sale of an investment bank contributed significantly to this positive effect.

Box 1. Hungary: Inflation Targeting Framework

In June of 2001, following the widening of the exchange rate band, the NBH adopted inflation targeting as its new monetary policy framework. The new Act on the NBH, enacted soon thereafter emphasized price stability as the NBH's primary objective, and as such, supported the inflation targeting framework. The following summarized the new policy framework's key characteristics: 1/

- The long run inflation objective is two percent, which the authorities consider as practically corresponding with price stability.
- To achieve this long-run objective, the following intermediate steps were formulated: achieving 7 percent by December 2001 (which, in the transition stage from one framework to the other, was more a projection than a target), 4.5 percent by the end of 2002, and 3.5 percent by end-2003. By adopting this path, the objective is to be consistent with the Maastricht criterion on inflation to adopt the euro by 2006–2007.
- The authorities have set a +/-1 percent tolerance band along the announced disinflation path to lessen the need for too active a monetary policy.
- The consumer price index was chosen as the most appropriate inflation indicator because it is a transparent indicator and fairly simple to understand.
- The central bank's primary instrument to attain the inflation goal is the change its benchmark interest rates. Given the small and open character of the Hungarian economy, the exchange rate is considered a major transmission channel. However, the NBH has no intention to intervene directly in the exchange markets (with the exception of emergency situations), but expects that its interest rate policy will affect the exchange rate and, through it, inflation.
- In light of the observed lags in the transmission mechanism of about 1.5 years, the target horizon is considered 1 to 1.5 years, or six quarters.
- In order to provide the public with a clear understanding of the NBH's policies, the central bank publishes the projections and considerations underlying the decision of the MC. Inflation projections will cover the upcoming six quarters. Fan-charts are used to present the public with the variety of risks that underlie the projections.
- The "Quarterly Report on Inflation" is the NBH's key document for presenting its projections and underlying considerations. Background papers further support this research. The decisions of the MC are announced in the press on the day they are made.
- Following the elimination of the crawling peg in October of 2001, the inflation targeting framework operates in conjunction with a wide exchange rate band (+/-15 percent around a central parity against the euro).

1/ Based on NBH, *"Quarterly Report on Inflation"*, August 2001; and NBH, *"Statement on the new system of monetary policy,"* June 12, 2001.

determine monetary policy and how the inflation forecast is arrived at. Decisions by the Monetary Council, the NBH's monetary policy decision making organ, are publicly announced and explained. The enhanced transparency underlying the new framework is expected to have a beneficial impact on market expectations.

17. **The new policy framework changed the operating environment for financial market players significantly, and proved to have a generally beneficial impact on financial market development.** Financial market players were confronted with an appreciating and more volatile exchange rate and lower and more volatile forint interest rates. Adjustment to this new operating framework by commercial banks was smooth, underlining the resilience of the system. More importantly, the new environment has boosted financial market development.

18. **In the wake of the foreign exchange liberalization, activity in the foreign exchange markets picked up.** Nonresidents became very active in the foreign exchange markets—the turnover of domestic customers and banks hardly changed. The daily turnover by nonresidents increased from almost zero in April 2001 to an average of the equivalent of 250 billion forint, about four times the average turnover of domestic customers and interbank taken together. The main growth took place in the swap markets, which were almost nonexistent prior to liberalization. On the other hand, the options and forward markets have not shown major signs of growth. Spreads in the foreign exchange markets widened after the liberalization to an average of 0.3 forint (from close to zero before). The forint interbank market also continues to deepen, albeit at a slow pace.

19. **The widening of the exchange rate band and the floating of the currency initially resulted in a decline in short-term capital inflows.** Following the changes in the policy framework, the stock of government paper with remaining maturity of less than one year in the hands of nonresidents declined, but has picked up again since October. By the end of the year it had again reached the level of the first months. The decline mainly reflected the unrest in the emerging markets in the middle of the year. More generally, investments by nonresidents in government securities markets remain a driving force of Hungary's bond markets.

20. **The deepening of the markets and the increased fungibility between forint and foreign exchange are strengthening the systemic liquidity framework.** A solid systemic liquidity framework is a crucial shock absorber in case shocks—be they exogenous or endogenous—hit the financial system. In this respect, one of the welcome effects of the new policy framework has been the solidifying of this framework (Box 2). Markets are deepening (and widening) steadily, new instruments are developing and, as a result, interest and exchange rate volatility remains manageable. Removing the legal uncertainties underlying the use of repos and pledges is also having a beneficial

Box 2. Hungary: Features of the Systemic Liquidity Framework

The capacity for banks to access liquid funding markets, in combination with their use of effective liquidity management tools are important aspects of financial intermediation in that they contribute to financial sector resilience. An environment that permits sound liquidity management facilitates market participants' managing of payments, transforming maturities and managing interest rate risk. At the same time, it supports effective and efficient transmission of monetary policy.

Hungary's new monetary policy framework has the ingredients in place to stimulate the further development of forint and foreign exchange money markets. In a recent paper discussing frameworks for systemic liquidity, 1/ Dziobek and others list the essential elements in the area of bank portfolio management and the supporting market liquidity infrastructure to arrive at solid arrangements. A brief overview of these elements shows that most of them are in place in Hungary nowadays, owning to the combination of the new policy framework and other (legal) improvements, mainly made in the wake of the 2000 FSAP assessment:

- *Bank liquidity* (the degree to which a financial institution is able to meet its obligations under normal conditions) for the banking sector as a whole is in a comfortable range. 2/ The share of liquid assets in the total balance sheet is around 32 percent, which is sufficiently high. Banks do not rely extensively on money market funds, those funds that are considered the most volatile source of funding. Nevertheless, liquidity is not evenly spread among the banks, which underlines the importance of a good market infrastructure in case of problems.

- *The infrastructure for day-to-day liquidity management support has become highly adequate.* Referring to the list of requirements in Dziobek and others (i) the HFSA monitors closely the prudential liquidity requirements for individual institutions established by regulation; (ii) the NBH's policy instruments that affect liquidity are adequate. The NBH operates standing facilities and the planned lowering of the reserve requirements will further contribute to market liquidity. There are no portfolio restrictions of any type imposed by rule or regulation; (iii) government debt instrument markets are further developing; (iv) the payments system arrangements are solid; (v) access to foreign exchange liquidity is now unrestricted following the removal of all capital controls; (vi) disclosure practices among market participants are conducive to market development; and (vii) the legal structure supporting creditor rights has been strengthened by removing the legal uncertainties surrounding repos and pledges. Finally, it should be noted that, while the effectiveness of the judicial structure in financial sector matters remains broadly untested, it is most likely in need of further improvements.

- *Safety net arrangements*, mainly consisting of NBH emergency lending and the presence of an explicit deposit insurance, are in place as discussed elsewhere in this report.

1/ Dziobek, Claudia, Kim Hobbs and David Marston (2000), "Toward a Framework for Systemic Liquidity Policy", *IMF Working Paper* WP/00/34.

2/ NBH, *Report on Financial Stability,* November 2001.

impact.[7] These new developments, together with the foundations that were already in place, have strengthened forint and foreign currency markets.

C. Going Forward—External and Domestic Risks

21. **Risks stemming from the exchange rate regime—discussed in the 2001 FSSA report—have diminished under the new framework.** More particularly, the report discussed the uncertainty regarding the extent to which foreign currency borrowing by the corporate sector was hedged. Since the new regime has been in place, banks have encouraged their clients through promotion campaigns to hedge exchange rate risks. As a result, hedging is slowly increasing. This is a reassuring development, together with the fact that a large proportion of bank customers have natural hedges, which reduces the indirect credit risk for the commercial banks significantly. Moreover, with the appreciation of the forint in the wake of the widening of the band (and the lowering of the forint interest rates), a significant number of domestic borrowers converted their foreign currency loans with domestic banks into forint loans, or moved from external borrowing to domestic borrowing, mainly in forint (Figures 1 and 2). Both changes diminish the borrowers' own direct, and the banks' indirect, exposure to foreign currency risks. The authorities are encouraged to monitor market developments, to ensure that the indirect credit risk for the commercial banks remains limited. This could be done through regular surveys of corporate sector exposures.

22. **Even though the turmoil in the emerging markets in 2001 had almost no effects on Hungarian markets, the authorities should continue to monitor developments carefully.** More particularly, the risk of volatility spillovers from the Polish foreign exchange market to the Hungarian foreign exchange market through common investors remains significant. This risk is often compounded when foreign bondholders (who typically hold unhedged positions in the local bond market—accounting for around 20 percent of total debt outstanding and 40 percent of turnover) begin to hedge their foreign exchange exposure during periods of increased volatility in the Polish and/or Hungarian currency markets. As indicated above, even though these markets in Hungary are deepening, this does not imply that they can accommodate sudden shocks right away.[8]

23. **The continuing lending boom to households is the main domestic development to be monitored.** In the course of 2001, mortgage lending has become the main form of lending to the household sector. Borrowing for housing is mainly driven by structural factors, but low interest rates and a highly generous housing subsidy program also play a part. The sharp

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[7] Under the previous bankruptcy provisions, lenders were not provided with a secured position in case of default of the counter party, making the use of collateral or pledges risky. Through legal provisions in the new Capital Markets Act these uncertainties were removed.

[8] On the other hand, should market perceptions shift in the direction of a slower pace of appreciation of the forint, or a weakening of the currency, some capital outflows could occur.

decrease in mortgage rates in 2000 led to a sudden acceleration of mortgage lending (Figures 3 and 4). In 2001, the expansion of the subsidy program was the main driving force behind the further growth. Total lending to households grew by 54 percent in 2001, compared to about 19 percent growth in total lending to the private sector.

24. **It is expected that growth in lending to the household sector will continue in the above range for some time to come.** Indeed, since March 2002, the subsidy program also includes mortgages for existing housing, while the interest rate subsidy was increased from 8 percent to 10 percent. Nonetheless, developments are not considered unsustainable. First, the credits to household are still a modest 6 percent of the banks' total asset portfolio. Second, the interest burden on households remains very low, at less than 2 percent of disposable income. Third, banks scrutinize mortgage applications carefully and only lend up to 60 percent of the value of the property. Nevertheless, staff emphasized that developments should be monitored carefully to avoid an unwanted deterioration in the quality of credit institutions' assets.

25. **Other potential challenges for the financial sector are also considered manageable.** Possible developments needing a close watch included (a) a sustained expansionary fiscal policy, which could lead to tensions in the financial system over time; (b) a continued appreciation of the forint, which could possibly threaten some large exporters and their ability to repay outstanding loans;[9] and (c) overheating of the commercial real estate market. On (c), there are no such indications to date, and loans to this type of activity remain under 6 percent of the banks' total private sector claims. The NBH's semi-annual *Report on Financial Stability* provides a thorough analysis of the international and domestic economic environment and its risk factors for the financial system. With the help of this document, and in cooperation with the HFSA, the NBH's banking department monitors stability issues closely.

IV. Soundness of the Financial System

A. Banking Sector Strengths and Weaknesses

Overall assessment

26. **The Hungarian banking system is well capitalized and liquid.** The banking system is well-managed and the dominance of top-tier foreign banks is a major contributor to this. Foreign strategic investors have clear commitments to maintaining the soundness of their Hungarian operations. The system is also well-supervised—major efforts are being undertaking to strengthen the oversight of the large financial groups—and banks comply broadly with all prudential requirements. Competition continues to rise in all segments of the

[9] However, in a small, open economy like Hungary, large exporters are often also large importers so that the effects of an appreciation on export prices would be largely offset through the import prices.

markets. This is likely to lead to pressure on profits in the medium term, and to further consolidation in the sector.

27. **While no serious threats to the stability of the banking system, or more broadly the financial system, are apparent, staff and authorities nevertheless agreed that continued attention needs to be given to some areas of potential concern.** Oversight of large financial groups is a key requirement to keep the system in check; principles of corporate governance are taking root but could benefit from stronger legal backing; the concentration of bank lending to a handful of large corporates needs monitoring; monitoring is also needed with respect to the fast growth in mortgage lending; and the sector of credit and savings cooperatives is in need of further consolidation. None of these are stability-threatening issues.

Development in markets

28. **In terms of developments in the lending markets, the year 2001 saw the continuation and acceleration of trends started in the late 1990s** (Figure 5). The corporate loan market is characterized by fierce competition—evidenced by the narrow interest margin of slightly above 2 percent (Figure 6)—and a high concentration of lending to a small number of large borrowers. The outstanding amount of foreign currency loans stagnated in 2001, which was more than a pure exchange rate effect (see above). The degree of concentration of lending to a small group of large enterprises did not increase compared to 2000.[10] While this feature may create problems for the commercial banks at times of a severe macroeconomic downturn, precautions have been taken. First prudential regulations require the banks to set aside capital against these loans in case the limit for large exposures is breached—a situation tightly controlled by the HFSA. Second, commercial banks are increasingly moving to syndicated loans to spread the associated risks.

29. **Bank retail lending continued to boom in 2001, albeit from a low level.** Competition in this market segment is increasing strongly, but mainly through nonprice elements. Indeed, interest margins are not (yet) narrowing. The average margin for retail lending is still around 12 percent. The great interest in mortgage loans—its causes are discussed above—is expected to last in the medium term, although the amount of dwellings is approaching the number of families quickly. While there are no signs that the situation is becoming unsustainable, close monitoring is recommended to avoid that a continuation of the rapid growth would lead to an unwanted deterioration in the quality of the banks' asset portfolio. As mentioned above, one important precaution taken by the banks is to limit the amount of individual loans to a maximum of 60 percent of the value of the property. On the other hand, several banks have established—or are establishing—a mortgage bank, a development that could lead to overcapacity in the medium term.

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[10] Roughly, the loans by the 10 largest banks to the 50 largest borrowers account for 40 percent of the total bank lending portfolio (covering 310 businesses).

30. **Bank profitability was exceptionally high in 2001. For the medium term, a decline to more modest levels is expected** (Table 4). The increase in profitability on the aggregate level was partly due to an on-off event, but was nevertheless substantial. However, more fundamentally, profitability seems to be concentrated in the largest banks (7 banks account for 70 percent of the sector's profitability), which might be indicative of the inevitable need for further consolidation of the sector in the medium term.

31. **Net interest income remains by far the main contributor to profits.**[11] The growth in 2001 in the absolute amount (almost 13 percent) is mainly due to the growth in the volume of lending to the retail sector where margins also remain substantial. With operating expenses remaining high and noninterest income growing slowly, the combination of a tapering off of the growth in lending from the current high level and narrowing interest margins is expected to put more downward pressure on bank earnings.

32. **Hungarian banks' capital adequacy and asset quality remain strong.** At end-September 2001, the CAR for the commercial banks stood at 15.2 percent of risk weighted assets, nearly the same as at the end of 2000. This stabilization follows a period of slow decline that was the result of higher provisioning, pressure on profits and faster growth of risk-weighted assets. All banks have a CAR above the minimum required 8 percent. A few banks, having a combined market share of 15 percent of deposits, have CARs between 8 percent and 10 percent.[12] The HFSA is closely monitoring these banks.

33. **Following a thorough clean-up of the loan portfolios in the mid-1990s, the overall quality of the asset portfolios continues to improve** (Figure 7). Classified loans (substandard, doubtful, and bad) were at 3 percent of the banks' total assets at the end of 2001. The slight increase compared to 2000 comes mainly from lending to the households, but still remains manageable. Meanwhile, the composition of the banks' balance sheets continues to change—lower investments in government paper, more private sector credit—creating potentially more credit risks for the banking system. On the other hand, these developments demonstrate that the banking system is maturing, as it is increasingly playing its financial intermediation role.

34. **Stress tests, undertaken by the NBH, confirm the general picture of a system that is able to absorb a wide range of shocks.** As part of it half-yearly stability report, the NBH undertakes stress tests on the individual banks.[13] The most recent tests (November

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[11] The (provisional) number for end 2001 is 3.7 percent of total assets. September numbers are traditionally lower than end-of-year numbers.

[12] Owing to the recapitalization of one bank in 2001, this share dropped from 25 percent to 15 percent of total deposits.

[13] The first stress tests were undertaken in the February 2001 issue, based on the methodology used in the IMF/WB 2000 FSAP. The NBH tests are based on individual bank

(continued)

2001) confirm earlier findings that losses following interest and exchange rate shocks would remain insignificant. On the other hand, credit shocks may lead to more significant losses for the banking system (an increase in NPLs by 2 standard deviations would wipe out 30 percent of the sector's core capital). However, the NBH notes that the low leverage of the Hungarian companies greatly reduces the likelihood of a shock this size. On the other hand, the presence of well-committed foreign owners is expected to prevent such a shock from taking on systemic proportions.

35. **The sector of cooperative credit and savings institutions is continuing its consolidation.** The sector manages about 6 percent of credit institutions' total assets (end 2001). The sector plays an important role in increasing financial intermediation in rural areas. At end 2001, there were 194 cooperative credit institutions, down from about 300 in the early 1990s. Consolidation of the sector is driven by the increase in the minimum required capital, necessary to meet EU standards. From a systemic point of view, the sector does not create any stability issues.

B. Developments in the Nonbank Financial Sector

36. **The rapid growth of the NBFIs continues, but no stability issues arise from these developments.** The NBFIs (insurance companies, pension funds, and ISPs) continue to expand their market shares within the financial system. In the middle of 2001, NBFIs managed 26 percent of households' and businesses' savings, up from 24 percent at the end of 2000. This growth is mainly driven by the activities of the pension funds. The consolidation that is taking place, in particular in the pension fund and investment firms sectors, is supporting the stability of the system. Institutional investors continue to follow a highly risk-averse policy—between 75 percent and 85 percent of their investments flow into government paper.[14] The new Capital Markets Act, adopted in 2001, has stimulated the growth of the capital market and added to its stability by further liberalizing the markets.

Insurance sector

37. **The most remarkable development in the insurance sector in 2001 was that the growth in fee income from life insurance contracts stalled.** The authorities saw several reasons for this development, none of which was seen as a major source of concern. First, the drop in premiums for unit-linked insurance contracts seems to be related to the less favorable developments in international capital markets. Second, taxations rules and changes therein also seemed to have had an impact on all types of life insurance contracts. Related to this, is a

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data, as opposed to the FSAP tests that were based on groupings of banks. The NBH is also widening the variety of scenarios.

[14] Insurers and pension funds are subject to limits on investments in foreign securities and foreign currencies. However, the institutions are currently not using these limits fully.

shift in long-term savings, away from life insurance in the direction of investments in pension funds.

38. **Notwithstanding the above developments, prospects for the entire insurance sector remain good and no stability issues were raised.** Profitability of the sector remained satisfactory. However, it is expected that margins will come under pressure in the medium term as a result of competition created by EU accession. Adopting EU standards will lead to a lowering of the maximum technical interest rate used to calculate reserves and a raising of the minimum profit participation rate. There is also a need to create a level playing field between mutual funds and unit-linked policies (the latter are less stringently regulated than the former) and also between insurance companies and the larger insurance associations.

Pension and mutual funds

39. **Growth in market shares of the NBFIs mainly comes from the pension funds.** After about four years of operation, the sector of mandatory pension funds is starting to stabilize.[15] No new funds entered the market in 2001 and the growth in membership is now determined by the number of people entering the job market.[16] These pension funds manage their portfolios very conservatively—the sector as a whole does not fully utilize the regulatory portfolio limits. The market of voluntary funds (in operation since 1994) on the other hand, is going through a wave of mergers, mainly dictated by efforts to improve cost efficiency and economies of scale. This development is expected to continue in the near term since many of these funds are facing increasing operating costs. This part of the sector is, therefore, less stable than that of the private funds, but does not raise any systemic issues. Some legal changes, implemented in the course of 2001 should enhance the transparency of the funds' operations—they are now required to report the value of their assets.

Investment firms

40. **The market of ISPs is undergoing a period of contraction and realignment.** Due in part to lower activity in the capital markets in 2001, the results of several independent firms (those that do not belong to a banking group) continued to deteriorate, leading to their exit from the market. Their number shrank from 28 in 2000, to 20 in 2001. The firms affiliated with larger financial groups turn out better results and form the stable part of the sector.

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[15] About half of the 25 mandatory funds are owned by banks or insurance companies.

[16] Since November 2001 new labor market entrants are no longer required to join the two-pillar system. The authorities also abolished the guarantees on the second pillar and kept the contribution rate at 6 percent (instead of the planned 8 percent). The measures could cause some outflows at the end of 2002, if participants decide to leave the two-pillar system.

C. Strengths and Weaknesses in the Payments Infrastructure

41. **Hungary has a well organized and efficient payments and settlement infrastructure.** The systems largely comply with the CPSIPS. The new NBH act and other official NBH publications have clarified the oversight role of the central bank. The main remaining challenge stems from the fact that multilateral netting is not recognized under the bankruptcy law and procedures. However, there is no systemically important payments system that operates on the basis of netting, which reduces the significance of this issue. Adoption of the provisions on settlement finality (in line with the EU directive), expected in the fall of 2002, will remove this legal uncertainty.

V. Legal, Regulatory, and Supervisory Framework

A. Overview

42. **Hungary's financial sector legal and regulatory framework underwent major improvements in the course of 2001. These improvements serve as an additional safeguard for the system's stability in the medium term.** In the aftermath of the 2000 FSAP effort and in the run-up to EU accession, several new acts on the financial sector have been adopted.[17] The new Credit Institutions Act sets the stage, among other improvements, for consolidated reporting and supervision. The new Capital Markets Act strengthens the supervisors' enforcement power, and further liberalizes the markets. Finally, the autonomy and accountability of the HFSA have also been strengthened. The AML/CTF legal framework has undergone substantial improvements. These legal efforts bring Hungary ever closer to international standards and practices. In the wake of the establishment of the HFSA, the agency works in the direction of harmonizing prudential and other relevant regulations across sectors (thereby minimizing the risks for regulatory gaps). Some areas for further strengthening remain, and the authorities are encouraged to seize the momentum offered by EU accession to finalize the task.

B. Financial Sector Regulation and Supervision

43. **New legislation has clarified and strengthened the position of the HFSA.** The amendments to the Act on the HFSA have clarified the rules on appointing and removing from office of the president and the vice-presidents of the HFSA. Also, the accountability of the president has been significantly clarified. The HFSA has budgetary autonomy. The institution is financed by fees from the supervised entities. The level of the fees is determined by the government. Furthermore, the HFSA has been strengthening and harmonizing its supervisory work in the respective sectors (the formation of on-site inspection teams composed of experts in the various sectors), herein helped by its new power to undertake supervision on a consolidated basis. The HFSA has been formalizing the issuance of guidelines to the supervised sector, as a means to circumvent the handicap that it cannot

[17] The new NBH Act was discussed in Section III.

issue legally binding regulations to the sector. The experience with these guidelines is increasingly positive in that financial institutions abide by them and these recommendations add predictability to the supervisory work. Nevertheless, as the process of issuing model rules as part of the AML effort indicates (see below), the work of the HFSA could be made more efficient and effective if the agency was given regulatory powers.[18] Formal cooperation and exchange of information with foreign supervisory agencies is also taking shape.

44. **Staff reassessed the key financial sector standards and updated the summary assessments presented in Section II of this FSSA.**[19] Compliance with the BCP has been further improved. From a systemic stability point of view, the most important innovation in the new Credit Institutions Act has been the introduction of consolidated supervision, and the requirement for financial institutions to report on a consolidated basis—a most welcome innovation in light of the dominance of large financial groups in the country. The definition of large groups has been broadened by also including groups not led by financial institutions. Other additions are also not without importance, including the new rules on the trading book; the regulation on capital requirements for market risks; stricter rules on country risk exposure; and some new accounting rules.

45. **Nevertheless, some deficiencies remain.** There is a need to strengthen the mechanisms to instill principles of good corporate governance in the financial institutions. The act does not give the supervisors the power to remove managers or board members directly in case of fraudulent actions. Fit and proper requirements could be further tightened particularly in light of the new anti-money laundering legislation. The requirements are sufficient as far as professional skills are concerned, but could be expanded beyond the simple requirement of absence of criminal convictions. The exception to lending to connected parties should be removed. Finally, the lack of a gradual ladder of sanctions to address noncomplying financial institutions could hamper the effectiveness of supervisory actions in case of problem bank resolution.

46. **Compliance with the IOSCO-principles has also increased following the introduction of the new Capital Markets Act.** Supervision of securities market participants has traditionally been weaker than banking supervision in Hungary, but the new act harmonizes standards and practices to a very large extent. In particular, the supervisors' enforcement powers have been upgraded. The new act has extended the powers of the SROs. To avoid

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[18] Granting the HFSA regulatory powers, however, might require a change in the Act on Legislation, which requires a two-third majority in Parliament.

[19] Reassessments took place for the BCPs, the IOSCO principles, the IAIS principles, the CPSIPS principles and the IMF's MPC code. In addition, an assessment was made of Hungary's anti-money laundering mechanisms including legal and institutional arrangements using the Fund's preliminary expanded AML/CFT methodology.

potential conflicts between the sanctioning powers of the HFSA and the SROs, coordination between these agencies is desirable.

47. **While a new insurance act is still in the making, some amendments were introduced in the course of 2001. They increased compliance with the IAIS principles.** The new act is expected to make insurance regulations EU-compatible and at the same time to bring insurance supervision up to the banking supervision standards. The 2001 amendments addressed the need for internal controls over the use of derivatives and increased the frequency of on-site inspections from five to two years. Remaining issues include the need to broaden fit and proper testing, legal backing of supervisors to instill good corporate governance principles in the institutions, and the need to make the on-site inspections more risk-based and forward looking, instead of checklist-driven.

C. Anti-Money Laundering and Combating Financing of Terrorism

48. **Hungary has made great strides in improving the legal framework for AML/CFT.** Staff reviewed the framework using the Draft Fund and Bank Methodology for Assessing Legal, Institutional and Supervisory Aspects of Anti-Money Laundering. Since its June 2001 placement on the list of noncooperating countries and territories by the FATF, Hungary has moved swiftly in its efforts to remedy the deficiencies noted by the FATF enacting provisions that reflect many recent recommendations of international bodies relating to anti-money laundering initiatives. A senior level inter-ministerial committee provides centralized policy coordination on anti-money laundering issues.

49. **The amendments to Hungary's anti-money laundering (effective since December 2001) address, among others, the two issues of most concern to FATF.** The law sets a timeframe for the elimination of the anonymous deposits and strengthens the mechanisms for the identification of beneficial owners. In addition, the amendments extend the range of financial and nonfinancial institutions covered so that, in addition to the banking, securities and insurance sectors, exchange bureaus, auditors, tax advisors dealers in luxury goods, and certain other professionals are covered. They also impose a customs cross-border cash transfer declaration and permit a 24-hour suspension for execution of monetary transactions in cases of suspicion.[20]

50. **On anti-terrorism financing, Hungary moved quickly after September 11, 2001 to make the provision of material assets for the commission of an act of terrorism an**

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[20] Further amendments (effective April 1, 2002) alter acts of commission so that a person may be charged with both the predicate offense and laundering and add the offense of negligent money laundering. The laundering offense extends to any kind of asset and the predicate crime is any offense punishable by imprisonment. The conceptual changes to the money laundering offense make it clear that a third party has liability for laundering of proceeds of an offense.

offense and established an inter-ministerial committee to coordinate efforts in the fight against terrorism. Hungary also enacted a provision that allows the government to impose restrictive measures by decree to meet international obligations (including those based on resolutions adopted by the U.N. Security Council or the Council of Europe). The authorities have recognized that amendments to the current anti-terrorism criminal provisions may be necessary to prohibit in a direct and unrestricted manner the provision of assistance to terrorists groups. Such provisions would enhance Hungary's ability to fight terrorist financing and fully harmonize its domestic law with the International Anti-terrorism Financing Convention.

51. **The Hungarian authorities have a framework in place for appropriate supervision and monitoring of regulations in the banking, capital markets and insurance sectors.** Government officials and the banking, insurance and capital markets sectors have a heightened awareness of potential susceptibility to money laundering and appear committed to minimizing such potential within Hungary. Hungarian officials, including the HFSA, the Financial Intelligence Unit, and prosecutorial authorities have shown a commitment to ensuring that the full scope of the 2001 act is operational.

52. **Staff identified a limited number of areas where further strengthening is desirable to effectuate more thorough and consistent application of laws and to promote efficient monitoring of compliance,** including (a) tightening the statutory standard for suspicious transaction reporting; (b) enhancing and harmonizing the legal requirements for fit and proper standards; and (c) reviewing the protections for owners/third parties in seizure and confiscation proceedings. In addition, the authorities should give attention to a review of resources, functions, and operational efficiency of the Financial Intelligence Unit at this critical juncture in the Unit's history. Finally, if the HFSA were to acquire regulatory powers, the current system of model rules could be replaced with a regulatory framework that affords greater flexibility to adapt to evolving needs.

VI. Financial Safety Nets and Crisis Management

A. Financial Safety Nets

53. **The three elements of a financial safety net—lender of last resort, deposit insurance fund, and adequate intervention powers and exit strategies—are in place in Hungary.** The NBH Act empowers the central bank to grant certain additional lender-of-last-resort facilities against collateral and can release the bank from complying with reserve requirements for three months. The operation and organization of the NDIF, established in 1993, complies with most parts of best international practice.[21] The agency is planning a

[21] The amount insured is Ft 1 million per depositor and includes domestic currency and foreign currency deposits. (The amount will be hiked in two stages to reach euro 20,000—approximately Ft 6 million—at the time of accession to the EU). The maximum premium is 0.2 percent of the insured deposits.

more sophisticated risk assessment system that will enable it to charge a risk-based premium with reference, not only to the capital adequacy ratio, but also to other factors, which have a bearing on the risks to the NDIF. The NDIF is legally obliged to choose the lowest long-term risk-option for the depositors, the credit institutions and the budget. The NDIF is obliged to work out crisis prevention measures in coordination with the HFSA. There is a cooperation agreement between the NDIF and the HFSA (which is not disclosed) that covers cooperation in examination, crisis management, and exchange of information.

54. **While the Credit Institutions Act provides the HFSA with sufficient intervention powers, the highly detailed character of such provisions does not leave the HFSA with much discretion in applying measures.** The Act defines the exact conditions of a bank crisis, and the HFSA may act only in relation to the definition set out in the Act. These definitions are not flexible enough to empower the HFSA to initiate prompt corrective actions and to be adequately proactive and preventive.[22] As indicated earlier, there is room for making the menu of remedial responses more efficient and flexible.

B. Crisis Management Arrangements

55. **Responsibility for problem bank resolution and crisis management is shared by the HFSA, the NDIF, the MoF and the NBH, as reflected in the Credit Institutions Act.** Systemic crisis management skills remain untested in Hungary, but coordination between the institutions involved seems well-established. The exceptions to the general principles of the bankruptcy law provided in the Credit Institutions Act for the liquidation of credit institutions are highly useful and make liquidation faster and more efficient.

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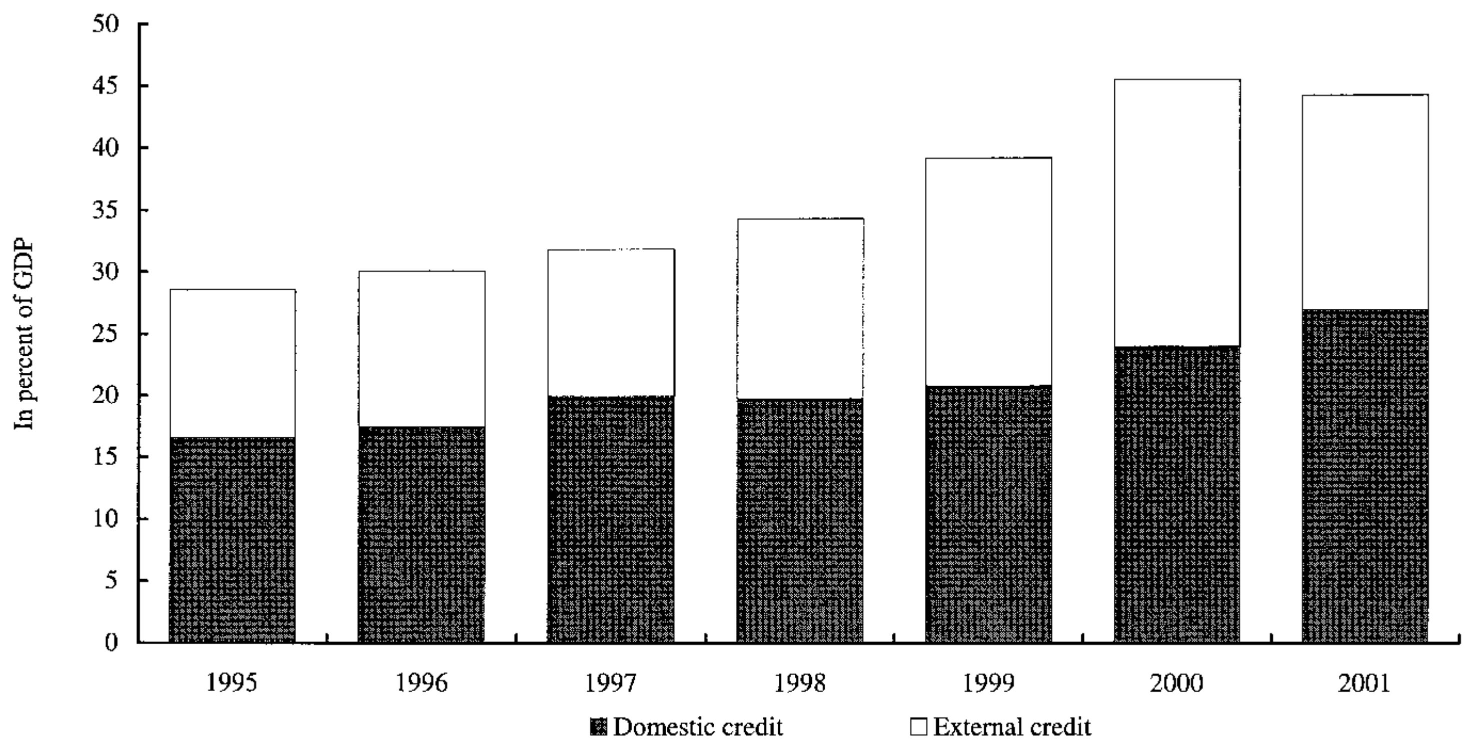
[22] For instance, the imposition of a temporary management, through delegation of a supervisory commissioner as the mandatory response when capital adequacy falls below 2 percent, is a diluted and ambiguous measure. A near insolvent bank faces strong incentives to assume additional risks, and delays could allow the institution to be stripped off its assets by employees and connected parties. Early intervention limits damage to the stakeholders in the bank.

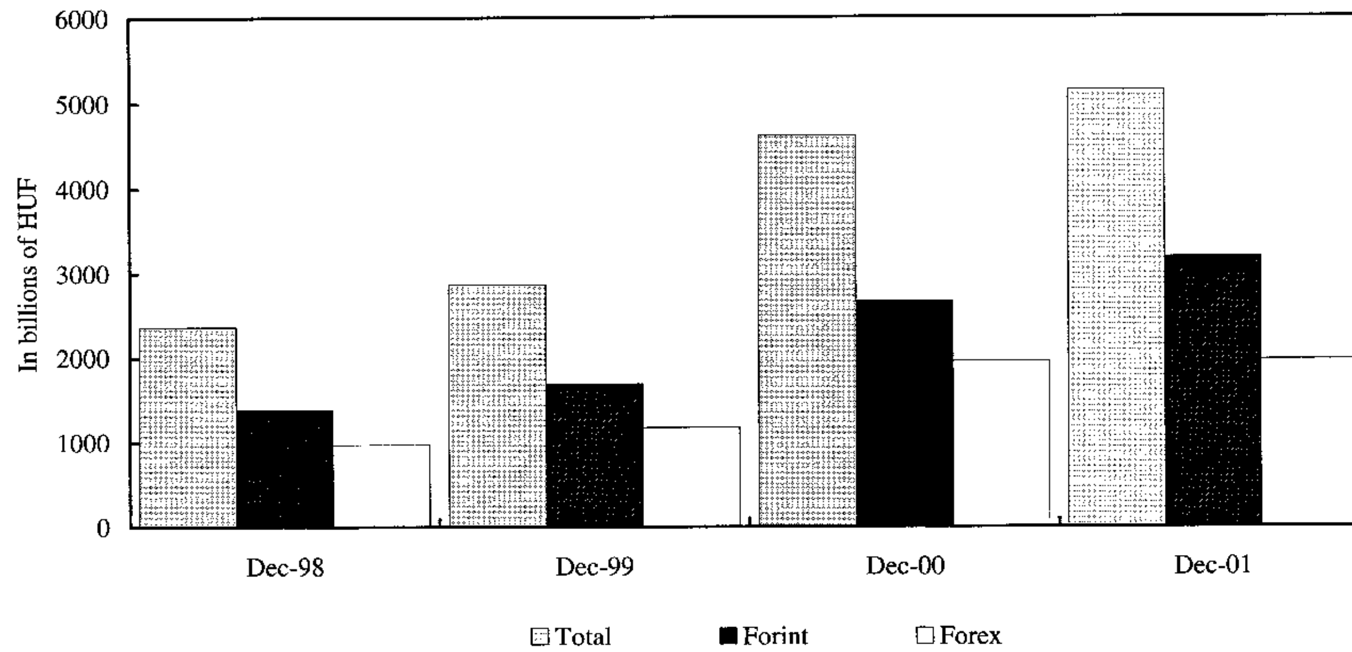
Figure 1. Hungary: Corporate Borrowing, 1995–2001



Sources: NBH; and IMF Staff estimates.

Figure 2. Hungary: Commercial Bank Lending

(In billions of forint, 1998–2001)



Source: NBH.

Figure 3. Hungary: Household Debt, 1997–2002

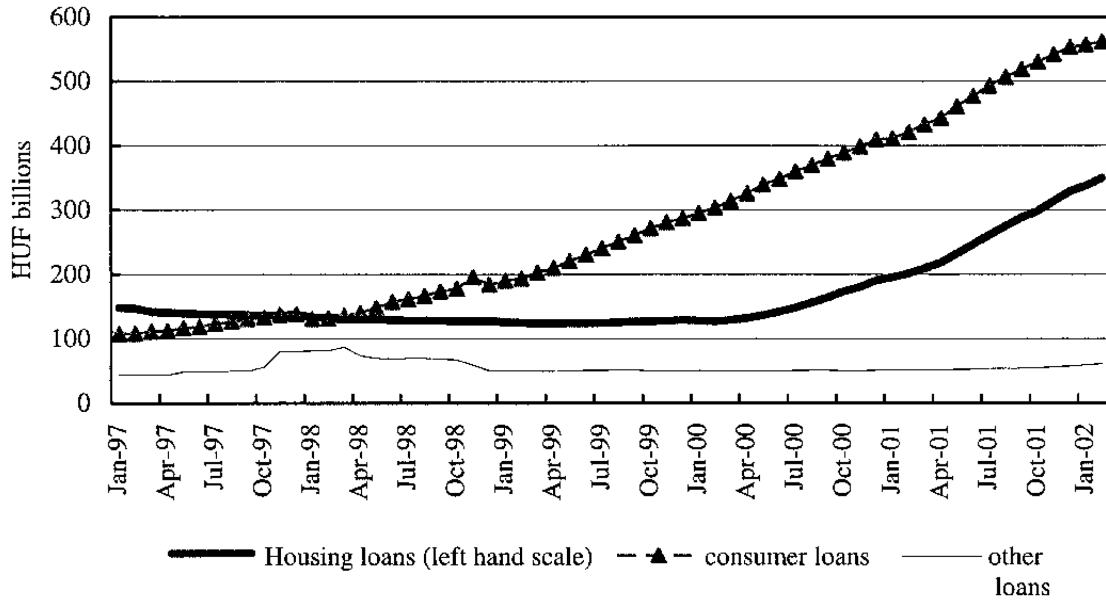
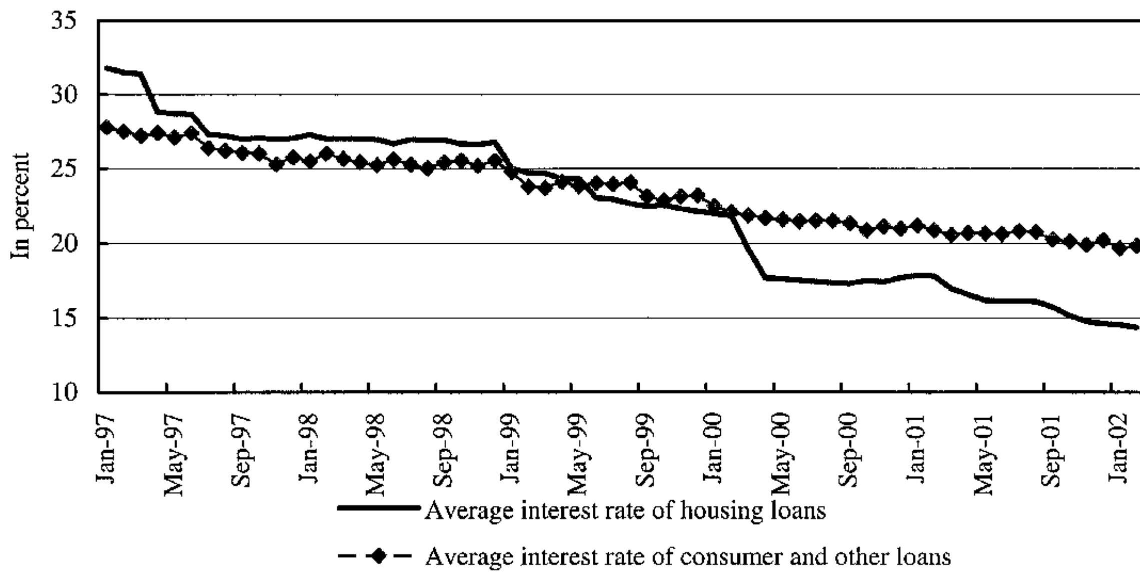
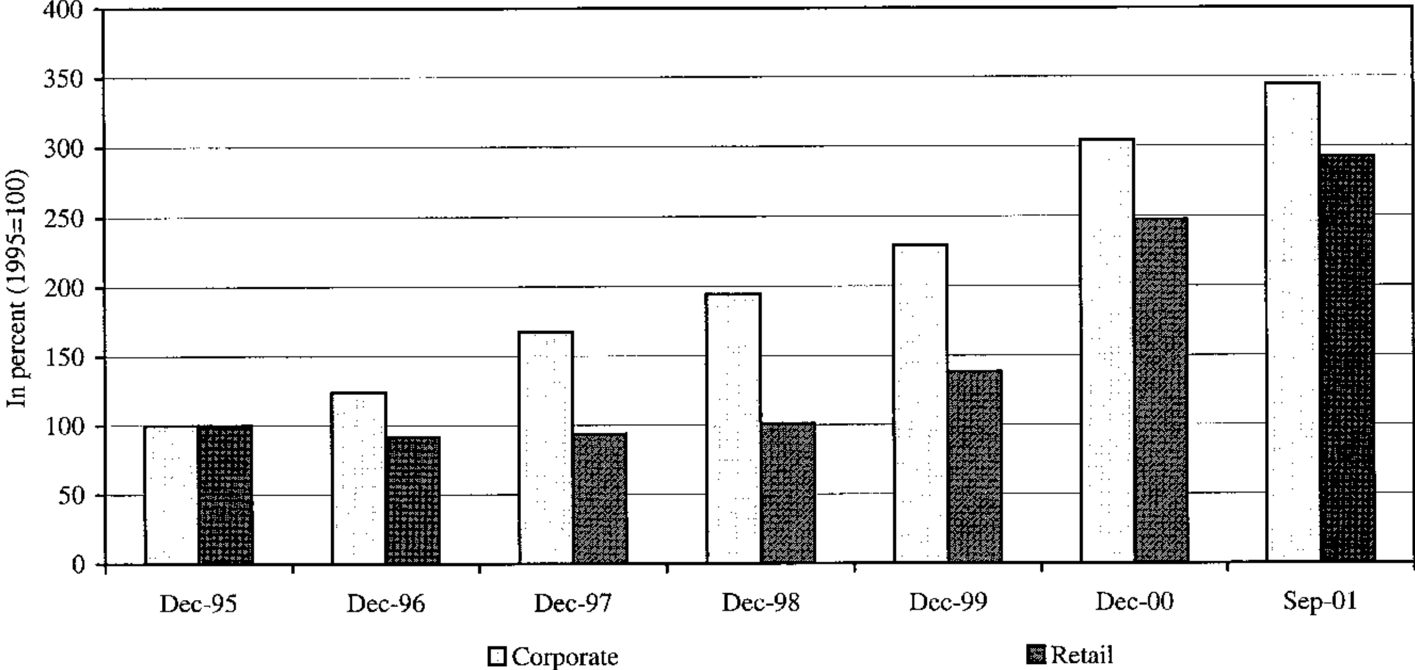


Figure 4. Hungary: Interest Rates on New Loans to Households, 1997–2002



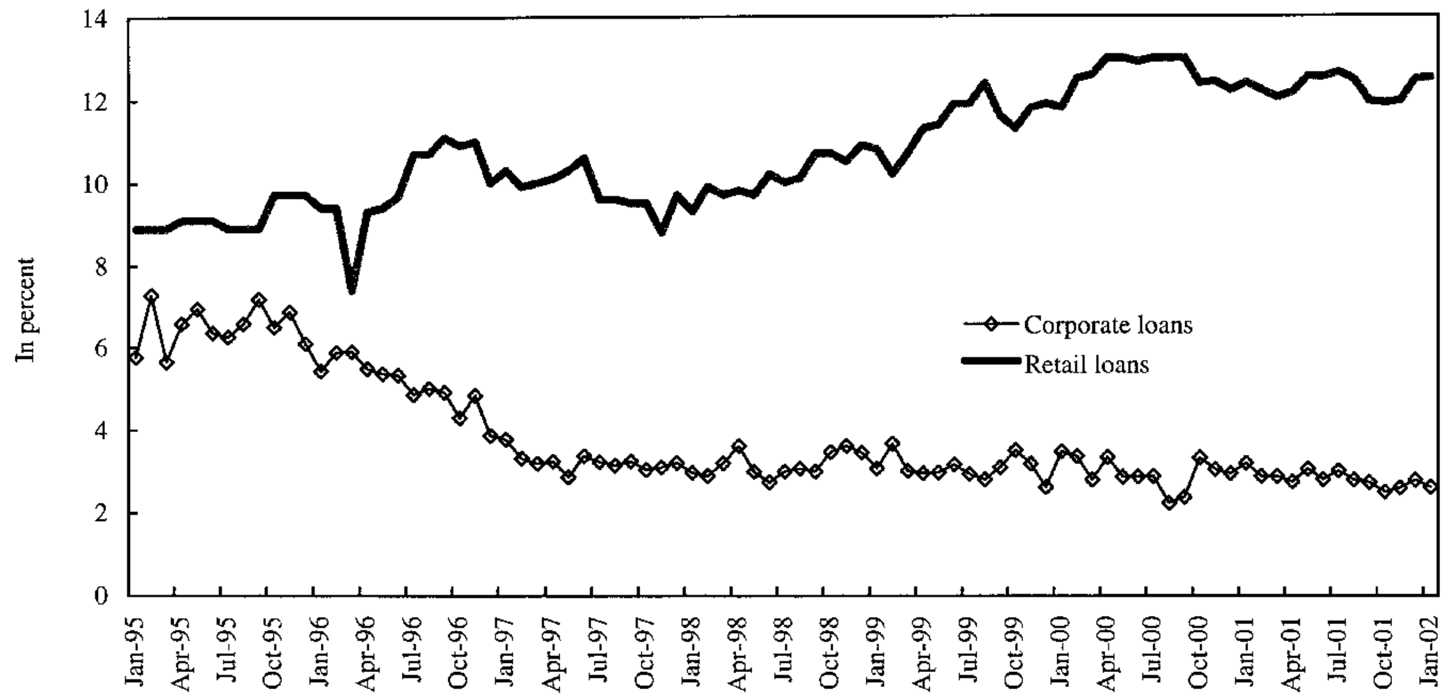
Source: NBH.

Figure 5. Hungary: Credit Growth, 1995–2001



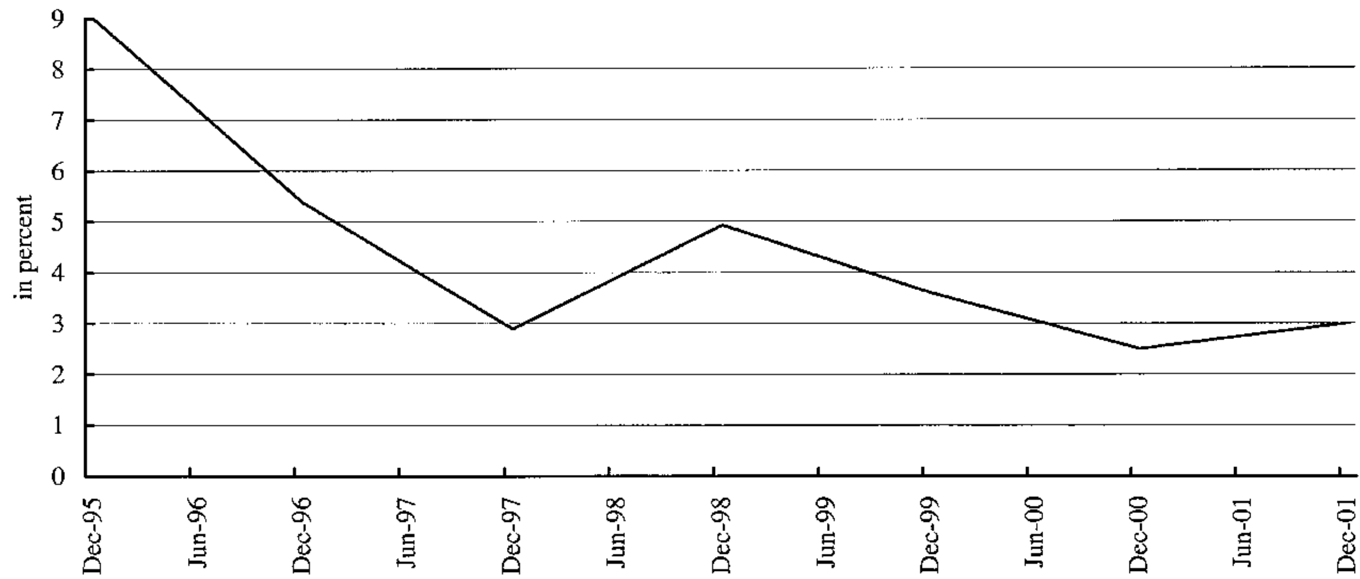
Sources: NBH; and HFSA.

Figure 6. Hungary: Average Lending Spreads 1995–2002



Source: NBH.

Figure 7. Hungary: Share of Classified Loans in Total Loans of the Banking Sector, 1995–2001



Source: NBH.

Table 1. Hungary: Financial System Structure

(In percent of total assets)

	Dec-98	Dec-99	Dec-00	Sep-01
Credit institutions	84.6	81.9	80.2	80.0
Investment firms	2.0	1.8	1.5	1.3
Investment funds	4.1	4.5	5.1	4.6
Insurers	5.4	5.9	6.3	6.9
Pension funds	1.6	2.6	3.6	4.0
Financial enterprises	2.2	3.3	3.5	3.4
Total	100.0	100.0	100.0	100.0
Total NBFIs	15.4	18.1	19.8	20.0

Source: HFSA.

Table 2. Hungary: Ownership Structure of Commercial Banks

(In percent of registered capital)

	Dec-98	Dec-99	Dec-00	Dec-01
Public sector ownership	20.7	19.3	21.3	25.0
Other domestic ownership	16.0	12.8	9.4	8.7
Foreign ownership	60.6	65.4	66.7	63.0
Other (preference/repurchased shares)	2.7	2.5	2.6	3.2
Total	100.0	100.0	100.0	100.0

Source: HFSA.

Table 3a. Hungary: Selected Macroeconomic Indicators, 1997–2001

Total population (Feb. 2002)	10.17 million
GDP per capita (2001)	$ 4,578

	1997	1998	1999	2000	2001
Real sector					
GDP (percentage change)	4.6	4.9	4.5	5.2	3.8
GDP (in billions of US$)	29.2	28.5	25.8	24.1	25.5
CPI (average)	18.3	14.3	10.0	9.8	9.2
Gross national saving (in percent of GDP)	25.6	24.8	24.4	27.9	25.3
Monetary and credit data (change in annual averages)					
Monetary base 1/	15.8	16.9	24.5	8.3	-0.9
Money (M1)	23.5	17.2	19.2	11.7	16.5
Broad money (M3)	20.3	14.9	16.5	12.1	17.2
Private sector credit	35.8	22.1	22.7	35.0	18.7
Interest rates					
Yield on government bills 2/	20.1	17.8	14.6	10.8	10.7
Yield on government bonds 3/	17.1	15.7	11.8	9.1	8.5
Reference bank lending rate 4/	21.8	19.3	16.3	12.6	12.0
Spread of benchmark bonds (basis points, end of period)	...	...	117.0	136.0	93.0
Stock market index	7,999.0	6,308.0	10,101.0	7,850.0	7,131.0
External sector					
HUF per US$ (period average) 5/	186.8	214.4	237.1	282.2	283.2
Trade balance (in percent of GDP) 1/	-4.3	-5.0	-4.6	-4.5	-4.0
Current account (in percent of GDP) 5/	-2.1	-4.9	-4.4	-2.9	-2.2
Foreign direct investment (net, billions of US$)	...	...	298.2	291.9	84.0
Portfolio investment (net, billions of US$)	...	...	2.0	-0.4	1.9
Gross official reserves (billions of US$, end period) 6/	8.4	9.3	11.0	11.2	11.0
Reserve cover (months of imports)	4.0	4.1	4.7	4.2	3.7
Reserve cover (short-term external debt)	2.8	2.6	3.0	2.8	2.5
Total external debt (in percent of GDP) 7/	54.6	55.8	64.5	66.8	65.1
Of which:					
Public sector debt	30.2	30.2	31.6	32.5	32.6
Financial system short-term foreign liabilities (in billions of US$) 8/	3.0	3.1	2.9	2.6	...

Sources: Bloomberg; IFS; MoF; NBH; and WEO.

1/ The decrease in 2001 reflects the reduction in the reserve requirement ratio from 11 percent to 7 percent in February 2001.

2/ Weighted average yield on 90-day Treasury bill sold at auctions.

3/ Five year average.

4/ Weighted average rate charged by banking institutions on loans to enterprises of less than one year.

5/ November 2001.

6/ December 2001. Imports of goods and services.

7/ Including intercompany loans as of November 2001.

8/ Remaining maturities of one year or less.

Table 3b. Hungary: Financial Soundness Indicators for the Banking Sector, 1997–2001

(In percent, unless otherwise indicated)

	Dec-97	Dec-98	Dec-99	Dec-00	Dec-01
Capital adequacy					
Regulatory capital to risk-weighted assets 1/	17.3	16.5	14.9	13.5	14.2
Capital (net worth) to assets	8.9	8.7	8.6	9.3	9.2
Asset quality					
Sectoral distribution of loans to total loans					
Manufacturing sector	...	31.3	29.2	27.2	27.1
Trade, repair, maintenance sector	...	19.4	20.8	20.2	18.6
Financial intermediation, other activities, real estate sector	...	15.9	16.5	16.1	18.1
FX loans to total loans	17.8	20.4	23.3	18.9	20.6
NPLs to gross loans 2/	2.9	4.9	3.6	4.1	3.8
Earnings and profitability					
ROA	0.8	-2.0	0.6	1.3	2.0
ROE	7.6	-26.7	6.7	15.1	20.2
Interest margin to gross income 3/	29.8	31.0	33.4	43.4	42.8
Noninterest expenses to gross income	23.9	25.7	32.5	40.7	...
Personnel expenses to noninterest expenses	...	41.2	39.3	40.7	...
Trading and fee income to total income	...	133.8	217.5	111.9	...
Spread between reference loan and deposit rates 4/	390.9	441.8	346.2	333.8	277.6
Liquidity					
Liquid assets to total assets 5/	42.4	42.4	48.2	42.0	30.6
Customer deposits to total loans 6/	52.6	53.7	50.1	49.2	47.0

Source: NBH, HFSA, IFS and staff estimates.

1/ The adjusted capital does not include any more the capital set aside for trading book, country and foreign exchange risks.

2/ Substandard, doubtful, bad assets as percentage of total assets for the banking system, June 2001.

3/ Income calculations for 1998 & 99 excludes Postabank, Realbank and MFB.

4/ Average short term loan rate and short term fixed deposit rate.

5/ Bank holdings of cash, government bonds, central bank bonds, and deposits as percent of total assets, June 2001.

6/ Corporate and household deposits as a percentage of total loans, june 2001.

Table 4. Hungary: Aggregate Income of Credit Institutions

(In percent of total assets)

	Dec-95	Dec-96	Dec-97	Dec-98	Dec-99	Dec-00	Sep-01
Net interest income	5.0	4.4	3.9	4.1	4.1	3.8	2.7
Non interest income	1.6	1.8	1.5	1.1	1.5	1.0	0.8
Net fee income	0.9	0.8	0.7	0.8	0.9	1.2	0.7
Other income	0.7	0.9	0.7	0.3	0.6	-0.5	0.0
Gross operating income	6.6	6.1	5.3	5.2	5.7	4.5	3.5
Operating expenses	3.4	3.3	3.4	3.7	4.1	3.3	3.2
Net operating Income 1/	3.2	2.8	1.9	1.5	1.6	1.1	1.3
Net provisions 2/	-1.0	-1.0	-1.0	-3.4	-1.1	0.3	...
Extraordinary profits and losses	-0.7	-0.1	-0.1	-0.1	0.0	-0.1	0.2
Pretax profit (ROA)	1.5	1.7	0.8	-2.0	0.6	1.3	2.0
Memorandum items:							
Interest rate spreads	5.0	4.7	4.3	4.2	3.7	3.7	...
Expenses on gross operating income	51.3	53.4	64.7	70.8	71.6	...	...
Return on equity (ROE)	17.5	19.7	7.6	–26.7	6.7	15.1	20.2

Sources: NBH; and HFSA.

1/ Pre-tax returns.
2/ Estimates of provisions for years 1995 and 1996 include general and specific provisions.

Section II—Observance of Financial System Standards and Codes: Summary Assessment

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

The updated summary assessments are based on the original detailed assessments undertaken during the 2000 joint IMF-World Bank FSAP. The updates were done by Fernand Naert (Belgian Commission for Banking and Finance) for the BCP and the IOSCO Principles of Securities Regulations; Marc Quintyn (IMF-MAE) for the CPSIPS; Martin Overbeek and Peter van den Broeke (Pension and Insurance Supervisory Authority, the Netherlands) for the IAIS' Supervisory Principles; and Marc Quintyn (IMF-MAE) for the IMF's MPC Code.

VII. Introduction

56. The significant changes to Hungary's legal and regulatory framework that took effect in the course of 2001 contribute to the stability of the financial system in the medium term. The updated summary assessments in this section confirm the progress made by Hungary in approaching international best standards and practices.

57. Major progress is noted in the following areas:

- New legislation has clarified and strengthened the position of the HFSA, in particular the rules on appointing and removing from office the president and the vice-presidents of the HFSA; the accountability arrangements; and the agency's budgetary autonomy. The HFSA has been formalizing the use of recommendations and guidelines to the supervised sector to promulgate best practices and make the supervisory work more predictable.

- Compliance with the BCP has been enhanced. The most important improvement in the new Credit Institutions Act has been the introduction of consolidated supervision, and the requirement for financial institutions to report on a consolidated basis—a most welcome innovation in light of the dominance of large financial groups in the country. Other additions include the new rules on the trading book; the regulation on capital requirements for market risks; stricter rules on country risk exposure; and some new accounting rules.

- Compliance with the IOSCO-principles has also increased following the introduction of the new Capital Markets Act. This new act upgrades the supervisors' enforcement powers. The act has provided the SROs with additional sanctioning powers. While

good in itself, this new situation requires additional coordination between the HFSA and the SROs.

- The amendments to the insurance act increase compliance with the IAIS principles. They address the need for internal controls over the use of derivatives and increase the frequency of on-site inspections from five to two years.

- Following the adoption of the new act on the NBH and clarifications published by the NBH with respect to its oversight role, compliance with the CPSIPS is complete. The adoption of the EU settlement finality directive, planned for 2002, will introduce the principle of multilateral netting in Hungary.

- Observance of the good transparency principles of the IMF's MPC Code is complete following the adoption of the new NBH act. In particular the operation of the NBH's MC, in conjunction with the inflation targeting framework has increased the transparency of the monetary policy decision making process. The amendments to the Act on the HFSA also enhanced the transparency of the agency's accountability arrangements, while the NDIF's operations have reached a level of complete transparency.

58. Areas for further attention include:

- The provision of binding regulatory powers for the HFSA to enhance efficiency and effectiveness of its operations.

- For all sectors: additional legal backing for supervisors to instill principles of good governance in the supervised sector. The acts do not give the supervisors powers to remove managers or board members directly in case of fraudulent actions. Related to this, a tightening and broadening (in particular in the insurance sector) of the fit-and-proper requirements.

- More flexibility for the banking supervisors in applying graduated sanctions to problem banks.

- The possibility of bank lending at more favorable terms to connected parties should be excluded.

- The insurance sector should continue to make on-site inspections more risk-based and forward looking, instead of checklist-driven.

Most of these shortcomings have a bearing on governance issues in the financial sector, and not so much on systemic stability. However, it is well known that poor governance practices, if not addressed or corrected, could lead to wider problems in the sector. The issues raised here are rather mild, but the authorities are nevertheless encouraged to address them in due course. The opportunity offered by the preparations for EU accession should be seized.

VIII. Basel Core Principles for Effective Banking Supervision

General

59. The assessment of the regulatory and supervisory framework for banking was performed under the FSAP in 2000 and updated in February 2002 . The main objectives were to assess the level of compliance with the BCP and to suggest areas for further improvement.

60. Responsibility for the legal framework governing the financial sector resides with the 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 nonbinding recommendations (guidelines). The system of issuing guidelines is gaining effectiveness in that they promulgate best international practices and make market participants better aware of the supervisors' opinion and therefore make the supervisory process more predictable. However, because of their nonbinding character, their effectiveness will always be in doubt.

61. The legal framework for banking and its supervision is set out in the 2000 Act on Credit Institutions and Financial Enterprises (ACIFE), and in relevant sections of the Act on the NBH. The ACIFE defines the responsibilities of the HFSA in supervisory matters. Prudential supervision is entrusted to the HFSA, as spelled out in the Act CXXIV of 1999 on the HFSA, amended through the Capital Markets Act of 2001 (Act CXX of 2001). The NBH's responsibility is restricted to monetary aspects and liquidity. The amended ACIFE aims at full compliance with relevant EU directives—certain stipulations in the Act will only take effect upon actual EU accession.

62. The detailed assessment of 2000 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. The 2002 update of the summary assessment was performed by Fernand Naert essentially through a review of changes in legislation and discussions with all parties concerned on the changes in structure and functioning of supervision.

Institutional and macroprudential setting, market structure—Overview

63. Hungary has one of the most developed financial systems among CEE countries. At the end of 2001, the banking system consisted of 41 commercial and specialized banks, and 7 credit cooperatives and 187 savings cooperatives. The latter account for about 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. The introduction of

group standards has contributed to a general improvement of standards in the banking industry.

64. 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 is increasing 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 CE countries and much lower than in developed economies.[23] The recent rapid pace of credit growth is deepening intermediation.

General preconditions for effective banking supervision

65. Since April 1, 2000, Hungary has moved to a unified financial sector supervisory framework. The Hungarian authorities saw the unification as a natural response to developments in the financial system, with financial conglomerates—in most cases headed by a banking entity—becoming the dominant type of structure. Under the new settings, 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. The amendments to the Act, adopted in 2001 through the Capital Markets Act, clarify the independence and accountability of the institution. Appointment and removal from office of the president is done by parliament, at the proposal of the prime minister. The amendments clearly stipulate appointment procedures, term of office and possible reasons for removal. They also lay out the president's reporting requirements. Budgetary autonomy is also ensured. The HFSA is funded through fees from the supervised entities. The level of the fees is determined by law. The authority of the HFSA in granting and withdrawing licenses is complete for NBFIs. For the banks, the HFSA has to request the approval of the MoF and the president of the NBH for withdrawing a license. The HFSA is not empowered to issue binding regulations.

66. The HFSA is in the process of harmonizing its regulatory and supervisory approaches across the supervised sectors, while at the same time taking care of the specifics of each of the supervised sectors. Operational integration of the HFSA is progressively realized but will still require priority attention for some time, especially of promoting the general perception of the HFSA as a truly integrated entity with all sectors.

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[23] 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. Furthermore the Hungarian economy, particularly the small- and medium-sized enterprises sector, appears to still be more cash-driven than is to be expected given its status of development.

67. The new structure has been built along five vertical lines of responsibility: financial supervision (on- and offsite), authorization and enforcement, complaints and customer relations, coordination, support, and, finally, 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.

68. The regulatory framework for banking and the banking supervision function of the HFSA is largely compliant with the BCP. A significant effort has been made by the authorities to enhance both the quality of the regulatory framework and the functioning of the HFSA in recent years. The ACIFE represented an important effort in adopting international best practices, and additional staffing and training improved the supervisory function. The act of 2000 further builds on these efforts. The most important change in the new act is the power to require reporting on a consolidated basis and to conduct supervision on a consolidated basis. The Hungarian authorities are fully committed to the goal of achieving full compliance with all BCPs.

69. Certain areas of less than full compliance may present risks to the stability of the Hungarian financial system. These are: (a) 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 and adequate manner; (b) the need for continuously building more comprehensive requirements for risk management, more rigorous rules on connected lending and on large exposures; (c) further focus and appropriate supporting rules addressing the nature and quality of board governance and oversight; and (d) the need for adequate discretion with regard to remedial actions, so that these can be used more flexibly. The current delays imposed by the law to use certain types of remedial actions and the still remaining rigidities by establishing "mechanical" ties between certain weaknesses and the remedies the HFSA can have recourse to, may lead to moral hazard in the system and potentially deepen crisis phenomena.

Main findings

70. 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, at its own discretion 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 and accountability arrangements are clearly spelled out in the new act. Dismissal is restricted to some legally-defined cases. The HFSA has published a clear mission statement in the course of 2000.

71. The only area where autonomy could be further enhanced is by empowering the HFSA to issue legally binding regulations. However, legal principles in the country require

that they be issued either by governmental or by ministerial decree. The HFSA is only entitled to issue noncompulsory recommendations to the sector.

72. The HFSA is required by law to provide information to the NBH, the MoF, the 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.

73. 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. The HFSA is mandated by law to deliberate and decide on any licensing on the basis of both a comprehensive set of standardized and 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.

74. 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.

75. 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.

76. 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.

77. There are 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). Excessive exposure may exist within the system, but needs to be 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. The Act does not prohibit banks to apply more favorable terms in their lending to connected parties. Both for connected lending and for risk concentration the banking sector could benefit from improvements in information on shareholdership and directorships.

78. The Hungarian legislation contains different rules for market risk. The gross open foreign exchange position of a 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.

79. Risk management processes are regulated for credit risk and foreign exchange risk, while there are recommendations for liquidity 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. Further extension of these dispositions will be required with regard to other types of risk under the upcoming new Basel Accord.

80. 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 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 this 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. With a view to implementing the upcoming new Basel Accord framework, it is recommended that the HFSA prepare a more qualitative risk-assessment as a basis of and a primary input for defining and planning supervisory action The rating-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.

81. The 2000 act provides for comprehensive rules on consolidated supervision and applies them to all groups that encompass a financial institution—a much broader definition than before. 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. The HFSA, by working in concert with major external audit firms and by providing for education opportunities for its staff, makes a comprehensive effort to overcome the lack of experience in this field en to ensure full and proper consolidated supervision.

82. The accounting standards are broadly in line with International Accounting Standards (IAS) 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, in particular as the upcoming Basel Accord attaches great importance disclosure (Pillar III). 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.

83. 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.

84. 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 have board members and senior management directly removed from office. The HFSA is authorized to call upon the Board of Directors and/or the General Assembly to discuss matters of removal and have these organs take a decision. In addition, the recourse to harder types of remedial actions is predicated on an institution being in a crisis or pre-crisis mode. Lack of effective and duly flexible remedial tools may create moral hazard in the system, and potentially deepen crisis situations.

85. 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 adoption of the principle of consolidated supervision, the HFSA should now also focus on consolidated supervision of Hungarian banks with foreign presence.

Table 5. 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. Mechanisms for autonomy and accountability have been spelled out in the law. The only area where autonomy is not ensured is on the regulatory side. The agency has no power to issue binding regulations. While its authority to grant licenses is complete, it needs prior approval from the MOF and the NBH to withdraw a banking license.
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 made by verifying shareholders' potential to sustain a credit institution's equity, and by tightening the fit-and-proper requirements. Fit and proper requirements are sufficient for professional skills but could go beyond the simple absence of criminal convictions.
Prudential Regulations and Requirements (CPs 6–15)	Additional strengthening of the Act would be welcome 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 should focus still more on internal systems and controls within banks rather than on strictly supervising compliance with formal prescriptions.
Methods of Ongoing Supervision (CPs16–20)	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 IAS. Improvements could be made regarding public disclosure of information by banks not listed on the stock exchange, particularly in view of the implementation of future international standards.
Formal Powers of Supervisors (CP 22)	Enhancements are desirable. 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 directly. Recourse to remedial actions is too much predicated on an institution being in a crisis or pre-crisis mode. Lack of effective and duly flexible remedial tools may create moral hazard in the system.
Cross-border Banking (CPs 23–25)	Following the recent adoption of the principle of consolidated supervision, the authorities should also focus on consolidated supervision of Hungarian banks with a presence abroad.

Authorities' response and recommended next steps

86. The Hungarian Authorities were in broad agreement. They stressed that the new Credit Institutions Act marked significant progress towards EU compliance and international standards. They agreed that some further steps need to be taken to achieve that latter goal. However, the authorities were of the view that the amount and nature of remedial tools were sufficient to tackle troubled banks.

IX. IAIS Insurance Supervisory Principles

General

87. The assessment of the Hungarian insurance sector supervision was performed as part of the FSAP for Hungary (February 2000). The main objectives were to assess the level of observance with the IAIS Insurance BCP and to suggest areas where further development was appropriate. The assessment was done on the basis of the draft IAIS Insurance core principles. The summary assessment was updated, based on the IAIS Insurance core principles of October 2000 (March 2002).

88. Insurance operations are governed by Act XCVI on Insurance Institutes and Insurance Activities of 1995 (the Insurance Act) and the amendments contained in Acts XCVIII of 2000 and LXXIV of 2001. A new act is planned to come into effect on January 1, 2003. The 2000 and 2001 amendments align insurance regulations with EU standards and harmonize the HFSA's supervisory methodology of the four financial sectors under its supervision.

89. Since April 2000, the HFSA is (also) responsible for supervision of the insurance sector. Its operations are defined in the Act on the HFSA (1999), amended in 2001, and further explained in its publication on fundamental principles of supervision.

90. The detailed assessment in 2000 was prepared by Dimitri Vittas (World Bank). This assessment was based on a review of the legal framework and discussion with the supervisory authorities. The update was prepared by Martin Overbeek and Peter van der Broeke (Pension & Insurance Supervisory Authority of The Netherlands). The HFSA, representatives of the industry, and the Association of Actuaries were very cooperative and provided all of the required data.

Institutional and macro prudential setting, market structure—Overview

91. Starting from a state monopoly in the mid-1980s, the insurance sector progressed through institution building and crisis resolution. 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 successful unit-linked policies, and business grew at a brisk rate until 2000. Growth tapered off in 2001, and life-business even shrunk somewhat. At the end of 2001, 26 insurance companies operated in Hungary, three more than the year before. Both the life and non life 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 increasing significantly. Insurance products are mainly distributed by agents and to a limited level by insurance brokers. The intermediaries are also supervised by HFSA.

General preconditions for effective insurance supervision

92. Hungary is broadly compliant with most of the insurance supervisory principles, but improvements in some areas are 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 HFSA publishes recommendations which promote best international practices and, as such, define the expectations of the supervisor with respect to the supervised financial institutions. Two main areas to be addressed are the need for legal powers to enforce principles of corporate governance in insurance companies and to ensure that the insurers and intermediaries exercise the necessary knowledge, skills and integrity in dealings with customers. The authorities are working to bring laws and regulations in line with the (draft) EU directives and to harmonize the regulations among the supervised financial sectors. It is expected that these amendments will be effective on January 1, 2003 or with the accession to the EU.

Main findings: summary

93. Hungary has created, as of April 1, 2000, an integrated supervisory authority for the financial sector, the HFSA. The integration process of the former agencies is a complex challenge and both its effectiveness and perception by the sector can only be correctly assessed over time. The HFSA is in the process of harmonizing laws and regulations across the supervised sectors. Projects are also running to harmonize methodologies as well as information technology without losing the specific aspects of each sector. On-site and off-site inspection has become more effective by using capacities formerly only available for one

sector. The quality of the staff is high. The HFSA undertakes proper efforts to keep the staff's knowledge permanently up-to-date, particularly with the still-growing presence of international insurers. Especially the knowledge of actuaries is considered a key area.

94. 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. 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 non life 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 fit-and-proper standards 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.

95. 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 10 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. It is not a standard procedure to assess the professional reliability of material foreign owners. Beyond this there is no requirement to obtain the consent of the home supervisor.

96. 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. The suitability of members of the supervisory board of insurance companies are not assessed. Insurance companies must appoint an external auditor and notify the HFSA of the appointment. Insurance companies must also appoint a chief-actuary who must verify all actuarial returns, all product plans and the annual report. 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.

97. 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 IAIS standard itself is 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.

98. 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 a manual with clear conduct guidelines to assess the effectiveness of internal controls used by both foreign and domestic large companies.

99. The Insurance Act places upper limits on the holding of different asset classes as well as concentration rules for individual securities to cover the mathematical reserve and security capital. 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. With regard to the international developments in asset valuation it is recommended that the applicable accountancy rules and decrees be modified to incorporate the valuation of assets in the financial reports. Insurers are not required to use the services of external custodians.

100. 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. All insurance companies have to employ, or at least have an agreement with, an actuary. It is practice that the chief actuaries of insurance companies are member of the Association of Actuaries in Hungary. Members have to meet the rules of this association in their daily work. These rules comply with international standards.

101. 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 (the requirement to do so is also not included in EU regulations). Most insurance products are distributed by agents and for a smaller part by brokers. No minimum educational requirements for intermediaries are established. The new Act intends to bring the requirements in line with the draft EU directive on intermediaries.

102. The amendments of 2001 spell out 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.

103. 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. For mutuals, the supervisor may require the cession of part of particular risks to reinsurance. Insurers are expected to consider the security of their reinsurers.

104. 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. The HFSA uses a monitoring system based on ratio analyses. This system has several ratio's but they do not yet fully match the specific elements of life and life insurance companies. HFSA is working on improving the system.

105. The HFSA has increased the frequency of its regular inspections of all insurers from five to two years. When there is lack of capacity to fulfill this requirement HFSA has to hire external specialists. 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. The on-site supervision is increasingly moving away from a checklist-driven approach to a risk-based approach.

106. 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 non complying insurer.

107. The HFSA is an active participant in the IAIS and is beginning to enter into agreements or MoUs with insurance supervisory authorities in other countries. The first one was signed in March 2002, and more are under preparation, notably with supervisory authorities of EU member states that have subsidiaries in Hungary. Insurance supervisors are subject to professional secrecy and are required to hold confidential information received in the execution of their duties.

Table 6. 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. The 2001 amendments ensured a high degree of budgetary autonomy and clarified the position and accountability of the HFSA president. HFSA has no legally binding powers, which may at times hamper the effectiveness of its work. Compliant in all other areas.

Licensing and Changes in Control (CPs 2-3)	HFSA has full authority for licensing insurance companies and withdrawing licenses. Fit and proper tests are limited to owners and senior management. The suitability of the supervisory board and of foreign owners should also be assessed.
Corporate Governance (CP 4)	The legal framework to enforce corporate governance in insurance companies needs to be strengthened. The amendments of 2001 did not address this crucial topic.
Internal Controls (CP 5)	Development of a 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)	It would be useful if the HFSA introduces standard asset valuation rules. The HFSA does not apply risk-based capital requirements, nor a dynamic solvency test, but neither of these is explicitly required by the IAIS standards.
Market Conduct (CP 11)	HFSA could establish minimum educational requirements for intermediaries.
Monitoring, Inspection and Sanctions (CPs 12-14)	No action required. The frequency of onsite inspections has recently been increased from five to two years.
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 initiatives to intensify cross-border coordination and cooperation with other supervisors.

Authorities' response and recommended next steps

108. The authorities are in broad agreement with the assessment. They underlined the critical steps embedded in the new amendments. It is recommended that the remaining areas of noncompliance, or weaknesses, be addressed in due course. They should be incorporated in the new Act, which is expected to take effect on January 1, 2003 or with EU accession. 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.

X. IOSCO Objectives and Principles of Securities Regulation

General

109. The assessment of the Hungarian securities regulations was performed as part of the FSAP assessment for Hungary in February 2000. 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.

110. 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. The update of the summary assessment was prepared by Fernand Naert (Belgian Commission for Banking and Finance).

Institutional and Macroprudential Setting, Market Structure—Overview

Supervisory framework

111. 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 Budapest Stock Exchange (BSE), the Budapest Commodities Exchange (BCE), the securities settlement system (KELER), securities intermediaries, issuance of securities to the public, and investment fund managers. HFSA also has, since the new Capital Markets Act of December 2001, full responsibility—alongside the BSE and the BCE—with regard to market conduct and sanctioning powers over market participants. Given the relatively brief history of capital market regulation in Hungary, the markets appear to be well-regulated and the HFSA has made significant progress in supervising the sector.

112. The HFSA's supervisory responsibilities over the securities sector are guided by the Act CXXIV of 1999 on the HFSA and its amendments made through the 2001 Capital Markets Act. Organization of market is regulated by Act CXX on the Capital Markets of December 2001. This law replaced most provisions of the Act CXI of 1996 on the Floating of Securities, Investment Services; the Act XXXIX of 1994 on the Commodities Exchange and transactions effected on the Commodities Exchange; and the Act LXIII of 1991 on Investment Funds.

Market structure

113. Hungary's securities markets grew dramatically up to early 2000. The overall market capitalization of the BSE increased from Ft 884 billion in 1994 to Ft 7,306 billion in 1999. In 2000 the capitalization dropped by 8 percent due to the lower activity. Much of the initial growth was a result of 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 some 70 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). Under the new Capital Markets Act, the HFSA can authorize each of both exchanges to list and trade all types of financial instruments. This implies that BSE and BCE will compete with each other

in a rather narrow and not very liquid market. Both exchanges are facing the challenge to redefine their position and strategy and might well have to follow the trend in Western Europe and opt for joining an international alliance.

General preconditions for effective securities regulation

114. Since the adoption of the Capital Markets Act, Hungary's securities regulatory regime conforms in most material respects with the implementation of the IOSCO Principles. With respect to the supervisory function, there is a perception in the market that since the establishment of the HFSA in 2000, the agency's enforcement actions—a weak point in the past—have improved significantly. More generally, the reputation of the HFSA in enforcement appears to have a significant impact on market participants. The provisions of the Capital Markets Act prescribe the application of separate sanctioning by the HFSA and the SRO, entailing potentially double sanctioning at different levels of intensity for the same acts of misbehavior. While not a real problem—such a situation exists in several countries—this necessitates more coordination than before between HFSA and SROs.

Main findings

115. The HFSA has no authority to issue legally binding regulations, but it has sufficient powers to perform its supervisory 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 underway regarding the adequacy of staff resources to meet the increasing supervisory demands.[24]

116. Hungary relies to a limited extent on SROs to fulfill some regulatory functions. The two existing SROs, the BSE and the BCE, still play little meaningful role in regulating and supervising important aspects of their respective markets. The main part of regulation and enforcement is still entrusted with the HFSA or at least subject to prior approval by the HFSA. The powers of both SRO's are limited to tracing and sanctioning smaller cases of misconduct, while important infringements are exclusively treated by the HFSA. Compared with many international markets where SROs play an integral role in the regulatory process and possess quasi-legal authority in that regard, the BSE and BCE appear to have little impact, despite the changes in the new Capital Markets Act.

117. By law, the HFSA is authorized to inspect and investigate organizations subject to its regulatory oversight, including BSE and BCE. 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

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[24] The original concerns stemmed 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. Significant efforts have since been made, together with the deep reorganization of the HFSA-services, to meet requirements.

revoke a license or appoint a supervisory commissioner, and initiate and conduct full-scale administrative proceedings/inquiries. It has also under its responsibility the prudential supervision of ISPs. More detailed and stricter reporting should be introduced. The HFSA's more direct involvement in these activities has contributed undoubtedly to strengthen the overall enforcement profile of the Hungarian capital markets. Its still increased powers under the new CMA are intended to continue this effort.

118. The HFSA and—to a limited extent—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 and negotiations with several others are under way. Pursuant to international agreements, 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 in line with those provided for by the EU-Directives, and must seek an appropriate exception should it wish to have such requirements waived.

119. Hungarian disclosure, accounting, and auditing standards are in their formal aspects 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. The monitoring of compliance with, and enforcement of, such reporting requirements should still be enhanced, despite significant efforts in the last two years. Issuers are also 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.

120. The HFSA is the sole authority to license investment fund managers. Until the entering into force of the new CMA a license could be granted only to those companies whose activities are limited exclusively to fund management activity and/or pension fund management activity; under the new law this has been broadened and fund managers can also perform other asset management activities. 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.

121. 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 ISPs. 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. In line with practices with regard to licensing credit institutions, the HFSA has adopted the practice of having the organizational aspects of the applicant's operations inspected before granting any license.

122. 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.

123. 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.

124. 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.

125. The HFSA monitors market activity independently of the BSE. It does not rely exclusively on information obtained form the BSE, but performs market surveillance of unusual price movements itself. A new department has been set-up within the HFSA to enhance this surveillance and enforcement efforts, a more performing IT- monitoring system is under development. Given the widespread perception that significant amounts of market manipulation in the past have gone virtually undetected or have been inadequately sanctioned, vigorous market surveillance by HFSA is essential to the credibility of the markets.

Table 7. 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 should continue regarding the adequacy of staff resources to meet the increasing supervisory demands and enforcement capabilities.
Principles of self-regulation (CPs 6–7)	Powers of HFSA and SRO, especially in sanctioning, should be adequately co-ordinated.
Principles for the enforcement of securities regulation (CPs 8–10)	The Capital Markets Act has strengthened the enforcement powers of the HFSA—a weakness under the old act.
Principles for cooperation in regulation (CPs 11-13)	More detailed and stricter reporting of ISPs should be required.
Principles for issuers (CPs 14–16)	In the past, 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 was relatively low. The HFSA and the BSE make good efforts to enhance compliance with international standards. Vigilance by the authorities will be required to ensure that such practices do not 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

126. The authorities were in broad agreement with the assessment. The new Capital Markets Act addressed several of the weaknesses discussed during the 2000 FSAP assessment and has increased compliance with EU directives. Areas for further attention are the need for further staffing; the position of the SROs, in combination with the respective powers of HFSA and SROs.

XI. CPSIPS Principles for Payment Systems

General

127. The assessment of Hungary's payment and settlement systems was performed under the FSAP for Hungary (2000) and a FSSA follow up (2002). The main objectives were to assess the level of compliance with the CPSIPS and to suggest areas for further improvement.

128. 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.

129. The detailed assessment was prepared by Harm-Jan Woltjer (the Netherlands Bank), followed-up by Marc Quintyn (IMF) 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. Staff cooperated fully with the conduct of the assessment.

Institutional and macroprudential setting, market structure—Overview

130. 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).

131. 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.

General preconditions for effective payment systems

132. Three payment and settlement systems are of systemic importance and compliance with internationally published standards is nearly complete. The Hungarian large-value payments system, VIBER, complies with the CPSIPS.[25] VIBER operates on a real time gross settlement basis. The new act on the NBH (2001) has removed the credit risks that existed for the NBH due to the legal uncertainties surrounding pledges. The NBH also complies with the CPSIPS 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

[25] 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.

IGS complies with the CPSIPS 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 CPSIPS-IOSCO task force.

133. The main remaining challenge for the systems based on the netting principle stems from the fact that multilateral netting is not recognized under the bankruptcy law and procedures. However, no systemically important systems operate on the basis of netting. The new act on settlement finality (in line with the EU directive), expected to be adopted by parliament in the fall of 2002 will remove this legal uncertainty.

Main findings regarding VIBER and IGS

134. The NBH Act entitles the NBH to provide settlement facilities and to act as system provider. Rights and obligations of the system provider and of the participants are based on contractual arrangements. These contracts 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.

135. The 2001 Act on the NBH (providing that pledges and collateral granted to the NBH as part of its monetary policy operations have a privileged status) and the 2001 Capital Markets Act (strengthening the legal status of pledges and collateral in general) removed the previously existing legal uncertainty with respect to pledges, which presented an area of risks for intra-day credit by the NBH. As such, Hungarian legislation is now fully aligned with the Treaty of Maastricht which obliges central banks in the European Monetary Union to cover all credit-transactions by taking adequate collateral.

136. 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.

137. All operating rules regarding VIBER are set out in bilateral contracts and a rule book, which is available on the NBH website. This information includes membership criteria,

responsibilities of the participants, collateral arrangements, etc. Participants in VIBER are not exposed to credit and counterparty risk.[26] 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, at the level of the system, there are no liquidity problems.

138. 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 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. In September 2001, VIBER extended its operating hours by 2 hours to allow for a smoother liquidity management by its participants.

139. All rules, liabilities and responsibilities regarding IGS are laid down in uniform bilateral contracts. The general terms of these contracts and possible variations 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 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 all 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. Typically, second processing cycles are run only once or twice in a month.

140. VIBER, in operation since the end of 1999, uses the same IT platform as the RTGS systems of Luxembourg, Ireland, and the central TARGET component, operated by the European Central Bank (ECB). The system meets the security levels and other requirements

[26] 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.

set for the European TARGET system, which in many areas go beyond the CPSIPS core principles. Change request and testing procedures are in place.

141. The SWIFT network and standard message 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, the other server immediately takes over its task (hot standby mode). A second, remote processing site is under construction and is expected to start operation in 2002.

142. IGS operates its own communication network with computer to computer links (a separately owned X-400 proprietary network). Only authorized people can send batches through the network and their authorization is automatically checked by the system and recorded. Adequate protocols ensure authentication, integrity and confidentiality of the message flows and 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 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.

143. From an operational point of view, VIBER 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, supports the NBH's monetary policy operations and the OTC markets very well. 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.

144. 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. Gross settlement of retail payments through IGS calls for large amounts of liquidity, 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.

145. Processing in IGS is time constrained. The process cannot be started before VIBER is closed and has to be finished before VIBER opens. Extended opening times of VIBER will lead to a further reduction of the IGS processing time and might create vulnerabilities for IGS operations.

146. 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 IGS. There are no restrictions on participation in the system provided certain technical requirements are met. The membership criteria are published and a well-established auditing company certifies that the applicant meets the criteria.

147. Governance by the NBH is ensured and documented in the NBH publication "Role of the NBH in ensuring the smooth functioning of payments systems, and in the regulation of payments services" (available on the NBH website). 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 and published on the NBH website. 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.

148. The Giro Clearing House Ltd, in charge of IGS, is subject to sound corporate governance principles. 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.

149. The CPSIPS 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 and in the Credit Institutions Act. The NBH is authorized: (a) to regulate payment services; (b) to oversee domestic payment systems; and (c) 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.

150. 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 payment services) concerning the oversight role of the NBH and the explicit formulation of its objectives.

Main findings regarding the securities settlement systems

151. 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 2002.

152. From an operational and organizational point of view, KELER broadly complies with the recommendations for securities settlement systems published by the joint CPSIPS-IOSCO task force. As for payments systems, the only unresolved issue for the smooth operation of securities settlements is the lack of a legal basis for multilateral netting.

Table 8. Hungary: Summary of Main Findings of Assessment of Observance of the CPSIPS

Subject	Main Findings
Well-founded legal basis in all relevant jurisdictions (CP 1)	Legal basis for payment systems is fine. The only pending issue is the lack of sound legal basis for multilateral netting. The adoption of the settlement finality act in the course of 2002 will remove this legal uncertainty.
Understanding of the system's impact on risks; and procedures for the management of risks (CPs 2-3)	No action required.
Final settlement; inability to settle by the participant with the largest single settlement obligations (CPs 4-5)	No action required.
Assets for settlement (CP 6)	No action required. Settlement takes place in central bank money.
Security and operational reliability; and contingency arrangements (CP 7)	No action required.
Practical for the markets and efficient for the economy (CP 8)	IGS required large amounts of liquidity. At the moment banks can use their required reserves, but in the future, they might need to rely on intraday credit.
Objective and publicly disclosed criteria for participation (CP 9)	No action required.
Governance of the system should be effective,	Good governance is ensured.

transparent and accountable (CP 10)	
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

The authorities were in broad agreement with the assessment.

XII. MPC Code—Monetary Policy

General

153. The assessment of observance of good transparency practices in monetary and financial policies by the NBH was carried out as part of the joint Bank-Fund FSAP in 2000 and updated during an FSSA follow-up in February 2002.

154. The assessment was based on IMF's MPC 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.*

155. The detailed assessment was prepared by Bruce White (Reserve Bank of New Zealand) and updated by Marc Quintyn (IMF). 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

156. The NBH is the country's central bank. Until July 2001, the Bank was governed by Act LX of 1991 on the NBH, and amended in 1991, 1992, 1994, 1995, 1996, 1997 (twice). A new Act LVIII entered into force in 2001 and made the central bank's objectives, basic tasks, and institutional and organizational set-up fully compatible with EU requirements. The high degree of observance of the Code on Transparency in Monetary and Financial Policies by the NBH and other agencies in charge of financial sector regulation and supervision underlines Hungary's continuous efforts to be in the forefront on issues of transparency and standards. As far as transparency in monetary policies is concerned, observance of requirements on clarity of roles, responsibilities and objectives of monetary policy is complete, as described in the NBH Act. Compliance is also complete with regard to the openness of the formulation and reporting of monetary policy decisions. 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 and the reasons for such changes. Meetings of the MC—its primary monetary policy decision-making body—are announced six months in advance. 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.

Main findings

Clarity of roles and responsibilities

157. The central bank is the NBH, responsible for the formulation and conduct of monetary policy. The **primary objective** of the NBH is specified in chapter I of the NBH Act: "...to achieve and maintain price stability." Article 1 states that the NBH "...shall neither seek nor take instructions from the government or any other body," in carrying out its tasks and duties.[27] The NBH's autonomy in monetary policy is further guaranteed by the stipulation in the NBH Act that the government may not instruct the NBH in relation to its scope of tasks as set out in the Act (article 38).

158. The NBH Act stipulates that the main **basic task** of the NBH is to define and implement monetary policy in the interests of maintaining the stability of the national currency.[28] Among the basic tasks, the Act also lists the promotion of the stability of the financial system and the development and smooth conduct of policies related to the prudential supervision of the financial system.

159. The governing bodies of the NBH are established by the NBH Act. The NBH is directed by a President, and at least three and at most five Vice Presidents. The organs of the NBH are the General Meeting, the MC and the Board of Directors. The President and Vice 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 Vice Presidents are laid down in the NBH Act. The Act also stipulates the obligation of the president of the NBH to report to the parliament. In practice this obligation is discharged through submitting an annual report and by appearing before the relevant committees of parliament to be examined on that report, as well as appearing before these committees on ad hoc matters as required. The act also stipulates that the NBH publishes a quarterly report on monetary developments and other important issues related to its basic tasks, and upon request by the government, provides information on an ad hoc basis with respect to monetary developments.

160. The **MC** is the highest monetary policy organ of the NBH and consists of between seven and nine members. The MC is in charge of formulating the NBH's monetary policy. It meets at least twice a month, according to a predetermined and announced calendar, but may be convened at any time if necessary. The operation and working methods of the MC are

[27] Article 3 states, in addition, that "without prejudice to its primary objective, the NBH shall support the economic policy of the government, using the monetary policy instruments at its disposal."

[28] This particular clause has been added to ensure consistency with the wording of the Constitution of the Republic of Hungary with respect to the position of the NBH (article 32/D).

161. governed by internal "Rules of Procedures of the NBH". At the moment these internal rules are not posted on the NBH website. The MC consists of the President of the NBH (as chair), the Vice Presidents of the NBH, and other members, appointed by the President of the Republic for a term of six years. These members should be Hungarian citizens with outstanding theoretical and professional knowledge of monetary, financial and banking issues. The members are submitted to the President of the Republic by the prime minister upon proposal by the President of NBH. Criteria for appointment, resignation and dismissal are prescribed in the NBH Act.

162. The **Board of Directors** is responsible for the implementation of the decisions of the MC and for the operations of the NBH. The Board consists of between four and six members—the President of the NBH as the chair and the Vice-Presidents of the NBH. The NBH Act (article 52) describes in detail the functions of the Board.

163. Article 45 of the NBH Act define the task of the **State Audit Office** as the inspection of the NBH's operations. The SAO shall check whether the NBH is operating in observance of the laws and other regulations, the statutes and the resolutions of the General Meeting.

164. The NBH Act clearly spells out 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. The Act states that the exchange rate regime is determined by the government, in agreement with the NBH. Within this framework, the NBH is responsible for implementing the exchange rate policy. The NBH Act is also clear and transparent on the issue of central bank credit to the government stipulating that the NBH may not grant credits to the government, local governments, other government institutions or economic organization operating under the dominant influence of the state of local governments.

Openness of monetary policy formulation

165. 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 as maintaining price stability. The NBH Act states that the NBH shall independently define its monetary policy and the instruments for implementing this policy. It defines that the NBH conducts monetary policy through accepting deposits from credit institutions and collateralized lending; open market operations; issuing its own securities; influencing or determining exchange rates and interest rates; refinancing; regulating minimum reserves; and other instruments of monetary control.

166. 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 key document is its **Quarterly Inflation Report,** providing (a) a comprehensive quarterly review of macroeconomic developments, with a particular focus on developments in monetary conditions and inflation, as well as (b) a forward looking analysis, setting out the elements

that determine monetary policy and how the inflation forecast is arrived at. This publication provides the reader with a good understanding of the framework within which monetary policy is conducted in Hungary. It is available on the NBH's extensive webpage. Its publication is accompanied by a press conference where also a brief summary is distributed.

167. The **MC,** as the policy-making body decides on the NBH's monetary policy stance, by deciding on the central bank's base rate. The MC meets every two weeks (or more if needed). The MC's work is prepared by the **internal monetary policy committee** which meets regularly (normally every weekly) to review recent developments and the outlook. This committee consists of the MC members, NBH managing directors and staff involved and its operations are regulated by an internal regulation. This committee is advisory in nature, with no formal powers. MC meetings also benefit from "Background Papers" prepared by NBH staff, at their initiative or at the request of the MC.

168. Changes to the setting of policy instruments are announced by the President of the NBH (or a designated person) following the MC meeting, that is around 4pm on the Monday of the MC meeting. The Board of Directors is in charge of implementing the MC's decisions. Announcement is by way of a press notice—with a brief explanation of the reason for the change. More substantive discussions of the considerations surrounding policy instrument adjustments follow in the next **Quarterly Inflation Report**.

169. The NBH publishes its balance sheet at monthly intervals, in its Monthly Report. Data on (gross) market transactions of the NBH, including data on gross transactions of its two main policy instruments (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.

170. The NBH's practice, when it has provided emergency financial support (in terms of the emergency financial support facility established by Article 14 of the NBH Act), has been to announce the operation shortly after the event. When this support was provided, it was always in the context of interventions by, and in coordination with, the supervisory agency.

Public availability of information

171. The NBH has a comprehensive publications program, including an Annual Report, a Monthly Report, the Quarterly Inflation Report, the Report on Financial Stability, Occasional Papers, Background Papers (for the MC), 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.

172. The semi-annual **Report on Financial Stability,** issued for the first time in August 2000 has become a key document among the NBH's regular publications. In light of the

importance the NBH is attaching to financial stability according to the new Act, this document provides the market with the NBH's in-depth views of the stability issues confronting the Hungarian economy and financial markets.

Accountability

173. Accountability of the President has been assured. The president of the NBH appears before the parliament to discuss the *Annual Report.* He may additionally be called to be examined on other matters at any time. Upon request, the NBH shall also provide information to the government on monetary developments and other important issues. The NBH's main policy document, the Quarterly Inflation Report is presented to the public during a press conference. The NBH's financial statements are audited by an external accounting firm. The firm receives a five-year, non renewable contract. 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.

174. 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 when exercising their duty, additional 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.

175. There is no published elaboration of the role of the internal audit.

Table 9. Hungary: Summary of Main Findings of Assessment of Observance of the MPC Code—Monetary Policy

Subject	Main Findings
I. Clarity of roles, responsibilities and objectives of central banks for monetary policy.	No action required. Objectives, roles and responsibilities are clearly spelled out in the Act.
II. Open process for formulating and reporting monetary policy decisions.	NBH has an open process for formulating and reporting policies. The Quarterly Inflation Report summarizes the projections and deliberations that underlie the decisions of the MC. The decisions of the MC are announced through press releases, providing reasons for the decision.
III. Public availability of information on monetary policy.	No action required. The NBH has a wide range of publications on monetary policy and financial stability.

IV. Accountability and assurance of integrity by the central bank.	No action required. The Act clearly specifies procedures for accountability.

Authorities' response and recommended next steps

176. The Hungarian authorities were in agreement with this assessment.

XIII. MPC Code—Hungarian Financial Supervisory Authority

General

177. The assessment of observance of good transparency practices in financial policies by the HFSA was carried out as part of the joint Bank-Fund FSAP in 2000 and updated during an FSSA follow-up in February 2002.

178. The assessment was based on the IMF MPC 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.*

179. The detailed assessment was prepared by Shyamala Gopinath (Reserve Bank of India) and updated by Marc Quintyn (IMF). 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

180. The HFSA is in charge of supervision of credit institutions, capital markets, insurance and pension funds. The agency was established by the Act on the HFSA (1999), and amended through the Capital Markets Act of 2001.

Main findings

181. The broad objectives of the financial sector supervisory authority is disclosed in the Act of 1999 on the HFSA, and the 2001 amendments to this Act. Broadly, the goals are to ensure the stability and efficient operations of the Hungarian financial market; protect the interests of the clients of financial institutions; ensure the transparency of the market and promote fair and lawful competition. The authority of the HFSA with respect to licensing, supervision and sanctioning is clearly spelled out, as well as the prudential rules and regulations it applies when supervising the financial sector. The 2001 amendments to the original act have laid out the accountability measures. In 2000, the HFSA published a mission statement to clarify its objectives, responsibilities and working methods.

182. The HFSA is governed by a Chairman and two Deputy Chairmen. The terms and conditions of appointment and dismissal of these officials are laid down in the Act. The term of appointment is for six years. Candidates for the post of Chairman or Deputy Chairman 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 Chairman is appointed by Parliament at the proposal of the prime minister. The deputies are appointed by the prime minister, at the proposal of the Chairman of the HFSA and submitted by the minister of finance. The term of the chairperson 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 agency by his activities.

183. 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 a 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 is posted on the website of both institutions. The agreements between the NBH and the HFSA are not disclosed. One such agreement provides for exchange of recurring prudential information. As regards the sharing of information with foreign supervisory agencies, the HFSA has at this moment formal arrangements or information sharing with Austria, Germany, and the New York State Banking Department. Several other MoUs are under negotiation.

184. The HFSA published its first annual report at the end of 2000. The main focus was on how the institution has been pursuing its overall policy objectives. The Annual Report 2000 (published in 2001) has been restructured and provides more information on the agency's supervisory role and on developments in the supervised sectors and markets. In addition, the HFSA publishes a Quarterly Report that deals with recent developments in markets and their supervision.

185. In dealing with the supervised sectors, 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 professional associations of market participants are consulted through meetings and written comments are also welcome. 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 HFSA has started to issue "recommendations" to the supervised institutions. Such recommendations have no legally binding character, but are meant to communicate to the market good practices. In this way the HFSA hopes to be able to modify market behavior, to instill the supervisory opinion into market behavior, and as such make supervisory behavior more predictable for the market. These recommendations can also be found on the HFSA's website. Plans also exist to issue "commentaries" on a regular basis.

186. The HFSA maintains a public information service whose function it is to disseminate policy decisions and policy announcements. The agency's website contains the information listed above as well as the annual report, related legal instruments, list of banks, broker houses, insurance companies and pension funds, and other registered market participants. At the time of the publication of the Quarterly Report, the President meets with the press. Press conferences are also organized on other, specific, occasions. President and other senior staff also give interviews to the press when circumstances call for it. This can be developments in the markets that require commenting, or changes in the supervisory approach. Inquiries by the public at large can be made in the HFSA's office for the public, through its website, or via a toll-free phone line.

187. The HFSA does not publicly disclose its financial statements. It is audited by the State Audit Office, but on an irregular basis. The HFSA operates under the oversight of the government, through the minister of finance. The HFSA operates as a separate budgetary chapter within the government. It is funded by fees from the supervised industry.

188. The chairman of the HFSA is required to inform the competent parliamentary commissions every year about the activities of the agency. This is done on the basis of annual report, which also needs to be submitted to the government.

189. The law on civil servants and the law on public administration procedures protects supervisors from being sued for actions undertaken as part of their professional work. However, in line with the situation for the NBH staff, the Banking Act and the Act on the HFSA do not provide additional legal protection directly to the HFSA staff. There is legal protection for the president and all the decisions made by HFSA are the responsibility of its president.

190. 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 10. Hungary: Summary of Main Findings of Assessment of Observance of the MPC 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.
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.	The accountability of the president has been satisfactorily addressed in the 2001 amendments to the Act on the HFSA. Policies on the conduct of financial

	affairs by staff are disclosed. The budget is only disclosed in a summary manner.

Authorities' response and recommended next steps

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

XIV. MPC CODE—PAYMENT SYSTEMS OVERSIGHT

General

192. The assessment of observance of good transparency practices in financial policies by the NBH with respect to payments system oversight was carried out as part of the joint Bank-Fund FSAP in 2000 and updated during an FSSA follow-up in February 2002.

193. The assessment was based on the IMF's MPC 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.*

194. The detailed assessment was prepared by Bruce White (Reserve Bank of New Zealand) and updated by Marc Quintyn (IMF). 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

195. The NBH is the country's central bank. The Bank is established by Act LVIII of 2001 on the NBH. The Act lists as one of the NBH's basic tasks to develop and regulate domestic payment systems and support their safe and efficient functioning. The central bank is also entrusted with the task of the regulation of payment services.

Main findings

196. The objective of the NBH's role in the oversight of payment and settlement systems is contained in Chapter I of the NBH Act and in a strategic memorandum, published in March 2001 ("The role of the NBH in the development and maintenance of the smooth operation of payment systems, and in the regulation of payments" available only in Hungarian). The objectives are defined with regard to private systems and systems operated by the NBH as well. The publication takes the CPSIPS Core Principles as relevant standards for payment systems and contains a concise assessment of VIBER and GIRO against these principles.

197. Two systemically important payment and settlement systems operate in Hungary and their operation is documented by the NBH in a number of background publications.[29] These publications outline the nature of the systems and provide some high level information on their risk. 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 CPSIPS. Specific risk management standards that the NBH seeks in payment and settlement systems have not been promulgated.

198. The fact that financial risks are well contained in payment systems helps explain why specific risk management principles for Hungary's systemically important payments and settlement systems have not (yet) been promulgated.

Table 11. Hungary: Summary of Main Findings of Assessment of Observance of the MPC 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.
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

199. The authorities are in broad agreement with this assessment.

XV. MPC Code—National Deposit Insurance Fund

General

200. The assessment of observance of good transparency practices in financial policies by the NDIF was carried out as part of the joint Bank-Fund FSAP in 2000 and updated during an FSSA follow-up in February 2002.

[29] The Blue Book of the ECB for accession countries (1998) contains a chapter with detailed description of the Hungarian payment and securities settlement systems. There is an occasional paper on *Payment Systems and Monetary Operations*, an explanatory booklet on the VIBER real-time gross settlement system, a study on the foreign exchange settlement risk and a detailed study on the Hungarian payment systems (updated version of the Blue Book (2001).

201. The assessment was based on the IMF's MPC 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.*

202. The detailed assessment was prepared by Shyamala Gopinath (Reserve Bank of India) and updated by Marc Quintyn (IMF). 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

203. The NDIF is the country's deposit insurance agency, established in 1993 and 1996 brought under the ACIFE.

Main findings

204. The Fund's establishment in 1993 was accompanied by a massive advertisement campaign to communicate its goals and objectives 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.

205. Formulation of NDIF policies is mainly limited to the setting of the level of the premiums. The bylaw on premium payments is published in the Official Gazette of the MoF. 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.

206. 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. Since 2001, the NDIF has started to put its Board decisions on its web-site. Given the confidential nature of some of the NDIF's decision, publication is at the Board's discretion, but so far 80 percent of its decisions have been made public. Also in 2001, the NDIF started the function of a "deposit insurance ombudsperson" through its website. Thus far, most requests to the ombudsfunction have been on additional basic information, somewhat different from the basic objectives of the function. The NDIF also

runs a deposit register that bank clients can consult to find out which of their bank's products are insured.

207. 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 in 2000-2001. The reports on the examinations were sent to Parliament and to the member institutions and the second one was placed on the website of the State Audit Office. The NDIF has publicly-disclosed policies on the conduct of financial affairs by its staff.

Table 12. Hungary: Summary of Main Findings of Assessment of Observance of the MPC 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, ombudsfunction, 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

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