

Self assessment based on the
Basel Core Principles
(1997, 1999)

December 2005

Principle 1: An effective system of banking supervision will have clear responsibilities and objectives for each agency involved in the supervision of banks. Each such agency should possess operational independence and adequate resources. A suitable legal framework for banking supervision is also necessary, including provisions relating to authorisation of banking establishments and their ongoing supervision; powers to address compliance with laws as well as safety and soundness concerns; and legal protection for supervisors. Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.

1 (1): An effective system of banking supervision will have clear responsibilities and objectives for each agency involved in the supervision of banks.

Essential criteria

1. Laws are in place for banking, and for (each of) the agency (agencies) involved in banking supervision. The responsibilities and objectives of each of the agencies are clearly defined.

In respect of the goals and responsibilities of the organisations concerned:

- *The responsibilities and goals are clearly specified in the laws.*
- *Although the supervisory task of the MoF is clear, it is implemented slowly, in a technically or professionally contestable way, sometimes without taken into account the Supervision's proposals.*
- *The separation of the responsibilities of the NBH and the HFSA is clear, yet in the area of money transfers it is being changed and clear separation of responsibilities has not yet been proven by facts.*
- *Cooperation between the HFSA, the NBH and the MoF is not functioning at the expected level in terms of Basel II or Crisis management either, primarily as a consequence of the MoF's attitudes (see also CP 1. (1) 1.3.*

In regulating banking activities:

- *The regulations of banking activities is practically conform to the best international practice but in respect of a number of important issues detailed in CPs it needs to be adjusted.*
- *The regulation of the operation of universal banks in the area of investment services (see. Self-assessment on capital market supervision). Two essential common themes: Chinese wall and in relation to this the fit and proper test, for only the licensed managers (quasi 'club members') can manage both areas of business life 'from on top of the wall'.*

In the area of consumer protection:

- *Consumers' aspects were taken particularly into account in the course of reorganisation.*
- *The HFSA act and the sectoral acts do not assign to the scope of the Supervision the performance of financial, consumer protection, information and training tasks either.*
- *As regards advertisements, the task clearly belongs to the Consumer Protection Inspectorate. Compliance with the rules on presenting the total loan charge ratio and the standard deposit interest rate is reviewed by the HFSA. Furthermore, the HFSA is also reviewing advertisements in practice; the Consumer Protection Inspectorate does not so often do so. (Reviewing misleading advertisements is a task for the Hungarian Competition Authority.)*
- *Reviewing the fulfilment of the obligation of supervised institutions to inform their customers is not suitably regulated (Article 206/A of the Banking Act: Consumer Protection Inspectorate: they have little expertise and do not carry out this task in practice)*

- *The consumer protection act covers only natural persons, but it does not actually cover the corporate business divisions of banks. This causes problems particularly in relation to the individual entrepreneurs (sole proprietors) and small businesses in the SME sector.*
- *Consumer complaint management entails problems. Out-of-court dispute settlement exists only formally, but in practice it is not really functioning. (One of the key reasons for this is that the conciliatory bodies have not built up their technical/professional authenticity.) In respect of this issue the Supervision contacted financial professional interest protection bodies in a letter during the self-assessment exercise.*

2. The laws and/or supporting regulations provide a framework of minimum prudential standards that banks must meet.

- *Although adequate and EU conform, the acts and other legal regulations are not flexible enough.*
- *The right to dispose is missing (although the system could be functioning in this way as well, but it is not).*
- *Recommendations could be applied more actively.*
- *The discretionary right hardly appears.*
- *Compliance with recommendations and the requirements laid out in methodology orientations is demanded in a heterogeneous way.*
- *In respect of prudential requirements permanent supervision should be developed with respect to the requirements of on-site and off-site supervision and planned liaising with the supervised institutions.*

3. There is a defined mechanism for coordinating actions between agencies responsible for banking supervision, and evidence that it is used in practice.

- *Based on experience the MoU between the HFSA, the NBH and the MoF has been reviewed recently.*
- *No practical lessons can be drawn from this as yet.*
- *Are 'policies, procedures and practices' coordinated? The crisis management plan has been created but its test is not acceptable. It is being revised.*

4. The supervisor participates in deciding when and how to effect the orderly resolution of a problem bank situation (which could include closure, or assisting in restructuring, or merger with a stronger institution).

- *The definition of the HFSA scope of competence is not adequate (e.g. in the case of savings cooperatives the scope of power of the supervisory commissioner).*
- *Deficiencies in preparing decisions to be made: cost/benefit analysis.*
- *In the case of withdrawing a licence the Supervision coordinates between the MoF and the NBH.*

5. Banking laws are updated as necessary to ensure that they remain effective and relevant to changing industry and regulatory practices.

- *Lack of a power to draft decrees (see also CP 21).*
- *Innovation is slowly followed by regulation.*
- *Issues of bank governance and the exercising of the rights of owners result in uncertainties.*

Additional criteria

1. The supervisory agency sets out objectives, and is subject to regular review of its performance against its responsibilities and objectives through a transparent reporting and assessment process.

- *A strategy has been developed (the result: 8 goals and 5 instruments).*
- *The criterion of competitiveness between the Supervision, the EU and other partner supervisions does not appear.*
- *Back-testing of targets is not carried out from the aspect of innovations or from the shift in supervisory focus in response to circumstances, or it is not consciously carried out.*
- *A necessary managerial need and requirement for the development of (work) plans and back-testing of their completion be carried out in concert with the basic goals and strategy of the institution.*
- *Backtesting is carried out on an individual basis, sometimes it is public.*

2. The supervisory agency ensures that information on the financial strength and performance of the industry under its jurisdiction is publicly available.

- *The HFSA home page has been prepared, it is being maintained and has been placed on a new platform.*
- *System of annual report and semi-annual public reports.*
- *Contents of published information?*
- *Lack of publications concerning the CG.*

1 (2): Each such agency should possess operational independence and adequate resources.

During the past 14 years since the establishment of the Hungarian State Banking Supervision in 1991 a total of 7 presidents have been leading the institution in charge of banking supervision (with different technical/professional and managerial orientations), None of them served their entire mandates.

Essential criteria

1. There is, in practice, no significant evidence of government or industry interference in the operational independence of each agency, and in each agency's ability to obtain and deploy the resources needed to carry out its mandate.

- *The management/governance or the operative autonomy of the HFSA is not adequately elaborated.*
- *In terms of operative autonomy even the existence of possibility needs to be assessed. Experience shows that it may be expedient to collect the ways in which the Supervision may, in order for or as a consequence of its operative activities, be under external governmental or political pressure: whether it can be excluded, reduced, whether the Supervision is prepared to act against it etc.*
- *In licensing and in the supervisory actions certain attempts at intervention have been observed, however, the question also arises from the aspect of how the agency (and, in particular, its managers at various levels) respond outside, and how much they convey of interested pressure, for that also contributes to the formation of culture.*
- *In regard to the budget the independence of financial management is guaranteed by legal regulations. The Supervision belongs to the MoF chapter. No attempt to intervene has occurred so far.*
- *Delays in approving the Organisational and Operational Rules.*

2. The supervisory agency and its staff have credibility based on their professionalism and integrity.

- *Publication of the HFSA code of conduct, setting up a body on ethics.*
- *Lack of the application of the HFSA's own fit and proper test.*
- *Human resource management and human policy of the HFSA.*

3. Each agency is financed in a manner that does not undermine its autonomy or independence and permits it to conduct effective supervision and oversight. This includes, inter alia:

- salary scales that allow it to attract and retain qualified staff;
- the ability to hire outside experts to deal with special situations;
- a training budget and program that provides regular training opportunities for staff;
- a budget for computers and other equipment sufficient to equip its staff with tools needed to review the banking industry; and
- a travel budget that allows appropriate on-site work.

Owing to the restrictions of the Budget Act the income structure is not attractive and does not retain professionals (levelling, restrictions on quality replacements, compared to the supervised sectors while our colleagues to those sectors instead of the state administration system).

Additional criteria

1. The head of each agency is appointed for a minimum term and can be removed from office during such term only for reasons specified in law .

This has not been fulfilled in substance. The president of the Supervisory Council is recalled by the Parliament (Status Act. 9/B§ (2));

In one case previously the president was removed through an amendment to the relevant act of law.

2. Where the head of an agency is removed from office, the reasons must be publicly disclosed.

The justification does not have to be published. Protection of publicity is not regulated by law.

1 (3): A suitable legal framework for banking supervision is also necessary, including provisions relating to authorisation of banking establishments and their ongoing supervision.

Essential criteria

1. The law identifies the authority (or authorities) responsible for granting and withdrawing banking licences.

It is determined.

2. The law empowers the supervisor to set prudential rules administratively (without changing laws).

The right to draft and adopt decrees is missing. The recommendations and the methodology orientations compensate for this lack, to some extent..

3. The law empowers the supervisor to require information from the banks in the form and frequency it deems necessary.

Extraordinary data provision and on-site audit is all right from this aspect.

Regular data provision is regulated by a MoF decree. This however, induces problems of amendment and intervention.

1 (4): A suitable legal framework for banking supervision is also necessary, including ... powers to address compliance with laws as well as safety and soundness concerns.

Essential criteria

1. The law enables the supervisor to address compliance with laws and the safety and soundness of the banks under its supervision.

- *There are no problems with legal compliance. The Supervision acts against violations of the written rules on safe and reliable operation (recommendation), on certain occasions. Based on Article 151 (1) of the Banking Act makes it possible for the Supervision where the financial institution or owner is not carrying out the activity with the expected due care. This rarely takes place, but:*
- *There is a permanent wrestle between Compliance and Prudential supervision approaches. This is a matter of attitude and supervisory style. Until recently, only supervisory activities relating to events breaching the law were laid out in resolutions. Though a positive change has been observed in the change in attitudes, the act on public administration procedures (Ket.) introduced recently, complicates its operation. Informal measures should be applied more frequently.*
- *The Supervision often proves to be helpless in relation to breaches of the unwritten rules of safe and reliable activities of permanent supervision.*

2. The law permits the supervisor to apply qualitative judgement in forming this opinion.

At present there is no effective supervision in this aspect. Owing to the legislative environment the right to carry out qualitative assessments is marginal. This problem could be eased if in relation to the enforcement of law resolutions, not contradicting concrete legal regulations but justified from a prudential aspect and properly supported by actual technical/professional arguments, were released more often than to date.

3. The supervisor has unfettered access to banks' files in order to review compliance with internal rules and limits as well as external laws and regulations.

4. When, in a supervisor's judgement, a bank is not complying with laws and regulations, or it is or is likely to be engaged in unsafe or unsound practices, the law empowers the supervisor to:

- take (and/or require a bank to take) prompt remedial action;
- impose a range of sanctions (including the revocation of the banking licence).
- *This is met in the case of breaching of a law or legal relationship. In the case of unsafe or inadequate practices there are differences in respect of the written law and technical aspects not based on written law. (see CP I. (4) 1.2.)*
- *The owner may also be obliged to carry out restoring action, which is applied by the Supervision only in exceptional cases.*

1 (5): A suitable legal framework for banking supervision is also necessary, including... legal protection for supervisors.

Essential criteria

1. The law provides legal protection to the supervisory agency and its staff against lawsuits for actions taken while discharging their duties in good faith.

Employees are protected.

2. The supervisory agency and its staff are adequately protected against the costs of defending their actions while discharging their duties.

1 (6): Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.

Essential criteria

1. There is a system of cooperation and information sharing between all domestic agencies with responsibility for the soundness of the financial system.

There is a legal framework (CP 1.(1) 1.3-4.), which is supplemented by the cooperation agreements concluded with all institutions concerned.

Eliminating of practical problems experienced in cooperation is in progress through reviewing the cooperation agreements.

2. There is a system of cooperation and information sharing with foreign agencies that have supervisory responsibilities for banking operations of material interest to the domestic supervisor.

3. The supervisor:

- may provide confidential information to another financial sector supervisor;
- is required to take reasonable steps to ensure that any confidential information released to another supervisor will be treated as confidential by the receiving party;
- is required to take reasonable steps to ensure that any confidential information released to another supervisor will be used only for supervisory purposes.

4. The supervisor is able to deny any demand (other than a court order or mandate from a legislative body) for confidential information in its possession.

The Supervision may deny such requests.

Principle 2: The permissible activities of institutions that are licensed and subject to supervision as banks must be clearly defined, and the use of the word “bank” in names should be controlled as far as possible.

Essential criteria

1. The term “bank” is clearly defined in law or regulations.

2. The permissible activities of institutions that are licensed and subject to supervision as banks are clearly defined either by supervisors, or in laws or regulations.

3. The use of the word “bank” and any derivations such as “banking” in a name are limited to licensed and supervised institutions in all circumstances where the general public otherwise might be misled.

The protection of the name has been provided for, the supervisory practice is not consistent enough in borderline cases, e.g. action against those using the word ‘bank’ in their company names (e.g. Ingatlanbank Kft.).

4. The taking of proper bank deposits from the public is reserved for institutions that are licensed and subject to supervision.

- *In disputed cases the Supervision decides whether a given activity qualifies as financial service provision.*
- *The problem of cooperative membership loan has been resolved.*
- *The activity of the consumer groups is in question.*
- *Change in attitude and practice has taken place in supervisory policy.*

Principle 3: The licensing authority must have the right to set criteria and reject applications for establishments that do not meet the standards set. The licensing process, at a minimum, should consist of an assessment of the banking organisation's ownership structure, directors and senior management, its operating plan and internal controls, and its projected financial condition, including its capital base; where the proposed owner or parent organisation is a foreign bank, the prior consent of its home country supervisor should be obtained.

Essential criteria

1. The licensing authority has the right to set criteria for licensing banks. These may be based on criteria set in law or regulation.

- *Completeness: fit and proper.*
- *Content: exercising of rights of owners.*

2. The criteria for issuing licences are consistent with those applied in ongoing supervision.

- *Legal-formal requirements are focused on primarily, in the course of the licensing process.*
- *In certain cases conducting, for instance, on-site audits could be of use, along with applying other instruments (not necessarily legal, e.g. supervisory pressure) in the case of institutions already operating.*
- *In order to ensure review of business plans submitted by institutions according to harmonised criteria a methodology instruction is being prepared.*
- *The reverse of the question also has to be dealt with: if in the course of operation it does not meet the licensing criteria, then is the supervisory action strict enough? (In the case of banks this question is not often raised in this way, except for one or another small bank, in the case of savings cooperatives, when it did emerge, the action was strict).*

3. The licensing authority has the right to reject applications if the criteria are not fulfilled or if the information provided is inadequate.

- *The Supervision is entitled to reject applications for licences.*
- *Applications of financial enterprises intended to be established have been turned down recently on several occasions. The Supervision has also rejected applications for the appointment of persons to managerial positions or for agents (e.g. money exchange agents, pledge agents) as well.*

4. The licensing authority determines that the proposed legal and managerial structures of the bank will not hinder effective supervision.

- *Preliminary professional reviews of managerial bodies and legal structures take place, organisation structures, managerial and decision making or controlling regimes are reviewed on the basis of the Organisational and Operational Rules or other internal procedures, but this is not carried out on the basis of a standard methodology or published requirements.*
- *In the case of doubt, verification of information provided by a foreign applicant by contacting foreign supervisory authorities may be a solution.*
- *The deficiencies of the special features of the structure and of the special measure of the Banking Act concerning savings cooperatives, is in progress, the Supervision has initiated modification of the Banking Act with respect to persons in a managerial positions in savings*

cooperatives, which would affect, in the case of savings cooperatives, the specification of the legal status of the supervisory commissioner as well.

5. The licensing authority determines the suitability of major shareholders, transparency of ownership structure and source of initial capital.

- In order to improve the accessibility of information concerning owners and ownership structure, required for licensing, an informative table has been produced for the competent employees concerning ongoing transactions of acquiring participations, on the Intranet.*
- Contacting foreign supervisory authorities and asking for information has become part and parcel of the ongoing supervisory activities.*

6. A minimum initial capital amount is stipulated for all banks.

7. The licensing authority evaluates proposed directors and senior management as to expertise and integrity (fit and proper test). The fit and proper criteria include: (1) skills and experience in relevant financial operations commensurate with the intended activities of the bank and (2) no record of criminal activities or adverse regulatory judgements that make a person unfit to uphold important positions in a bank.

- Reviewing the qualifications, managerial experience, legal incompatibility and clean criminal records of the members of governing bodies (Board of Directors, Supervisory Board, Board of Management) is carried out as part of the licensing procedure.*
- Good renown is not reviewed in the course of the procedure (for lack of statutory authorisation), the Supervision has no discretionary power, but the Supervision may apply the method of moral impact, which it does apply on individual occasions, but assessment of personal integrity is not general practice in the course of licensing.*

8. The licensing authority reviews the proposed strategic and operating plans of the bank. This includes determining that an appropriate system of corporate governance will be in place.

- Assessment of the medium term business plan in the course of the audits, and the universal banks have to produce activity plans in the course of the licensing process, facilitating the checking of whether the requirements of prudential operation are met.*
- Methodology orientation is prepared to ensure assessment of business plans submitted by institutions according to standardised criteria.*

9. The operational structure is required to include, *inter alia*, adequate operational policies and procedures, internal control procedures and appropriate oversight of the bank's various activities. The operational structure is required to reflect the scope and degree of sophistication of the proposed activities of the bank.

The operating structure is reviewed by checking the internal procedures relating to the organisation structure, management, decision and controlling systems.

10. The licensing authority reviews pro forma financial statements and projections for the proposed bank. This includes an assessment of the adequacy of the financial strength to support the proposed strategic plan as well as financial information on the principal shareholders of the bank.

The review could be assisted by developing a common set of criteria and minimum requirements.

11. If the licensing authority and the supervisory authority are not the same, the supervisor has the legal right to have its views considered on each specific application.

- *This is not applicable in Hungary.*
- *In the course of the licensing procedure the Supervision asks for the preliminary opinion of the National Bank of Hungary as well.*
- *Within the Supervision the competent technical/professional organisation units also comment on requests.*

12. In the case of foreign banks establishing a branch or subsidiary, prior consent (or a statement of “no objection”) of the home country supervisor is obtained.

13. If the licensing, or supervisory, authority determines that the licence was knowingly based on false information, the licence can be revoked.

- *The Act enables rejecting an application, if the applicant provides misleading or incorrect data. The only thing to be checked is whether the data are correct, the question whether the applicant acted on a bona fide or on a mala fide basis, does not matter.*
- *If misleading (or any other breach of the law) is learned about by the Supervision at a later stage, the licence can be withdrawn. Providing proof becomes more difficult as time passes.*

Additional criteria

1. The assessment of the application includes the ability of the shareholders to supply additional financial support, if needed.

- *Shareholders having 5-10% participations have to be identified in the course of licensing. The fit and proper test of the shareholders having qualifying participation is carried out in the course of the licensing procedure.*
- *Indirect shareholders are also checked in addition to direct shareholders.*
- *When actual beneficial owner is not known, this requirement is not met.*
- *The criteria of capability checking have not been fully developed yet.*

2. At least one of the directors must have a sound knowledge of each of the types of financial activities the bank intends to pursue.

- *This is not required by law.*
- *Competence level and competence requirement is not checked.*

3. The licensing authority has procedures in place to monitor the progress of new entrants in meeting their business and strategic goals, and to determine that supervisory requirements outlined in the licence approval are being met.

Shortcomings of licensing monitoring.

Principle 4: Banking supervisors must have the authority to review and reject any proposals to transfer significant ownership or controlling interests in existing banks to other parties.

Essential criteria

1. Law or regulation contains a clear definition of “significant” ownership.

The Company Act (Gt.) defines significant influence (shareholding), the Banking Act defines controlling influence and qualifying shareholding..

2. There are requirements to obtain supervisory approvals or provide immediate notification of proposed changes that would result in a change in ownership or the exercise of voting rights over a particular threshold or change in controlling interest.

- *There are statutory requirements for approving the acquisition of ownership, which are applied by the Supervision in the course of the licensing process.*
- *Its applied methodology has not been properly standardised. The methods of scrutinising actual beneficial owners have not yet been properly elaborated or applied.*

3. The supervisor has the authority to reject any proposal for a change in significant ownership or controlling interest, or prevent the exercise of voting rights in respect of such investments, if they do not meet criteria comparable to those used for approving new banks.

The Supervision has rejected several applications for acquisition of participation or has set conditions for exercising the right to acquire ownership.

Additional criteria

1. Supervisors obtain from banks, either through periodic reporting or on-site examinations, the names and holdings of all significant shareholders, including, if possible, the identities of beneficial owners of shares being held by custodians.

- *The identification data of shareholders having participations above 5-10% have to be provided upon establishment.*
- *The fit and proper test of the shareholders having qualifying participation is carried out in the course of the licensing procedure.*
- *Indirect shareholders are also checked in addition to direct shareholders.*
- *In some cases identifying and controlling the actual beneficial owners is a difficult task.*
- *In respect of identifying the persons actually benefiting from shares in custody the most typical example was that of OTP Bank, the procedure is still underway, some progress has been made but no breakthrough is expected owing to limited possibilities .*

Principle 5: Banking supervisors must have the authority to establish criteria for reviewing major acquisitions or investments by a bank and ensuring that corporate affiliations or structures do not expose the bank to undue risks or hinder effective supervision.

Essential criteria

1. Laws or regulations clearly define what types and amounts (absolute and/or in relation to a bank's capital) of acquisitions and investments need supervisory approval⁴.

2. Laws or regulations provide criteria by which to judge individual proposals.

- *Banks' investment limits concerning non-financial institutions is low (5 % of the regulatory capital), if the investment exceeds this limit, the excess has to be covered by capital.*
- *Financial investment has to be subtracted from the regulatory capital, which, incidentally, is subject to licensing above a 10 % share of ownership.*

3. Consistent with the licensing requirements, among the objective criteria that the supervisor uses is that any new acquisitions and investments do not expose the bank to undue risks or hinder effective supervision. The supervisor determines that the bank has, from the outset, adequate financial and organisational resources to handle the acquisition/investment.

- *The potential risk of activities in the licensing process would necessitate a preventive approach. By contrast, on the basis of data supplied on risks we draw conclusions concerning already operating institutions on the basis of the on-site audits.*
- *The requirement is formally met, but in matters of content there are uncertainties in relation to the assessment of financial and organisational resources.*

4. Laws or regulations clearly define for which cases notification after the acquisition or investment is sufficient. Such cases should primarily refer to activities closely related to banking and the investment being small relative to the bank's capital.

- *The law prescribes limits. Shares of ownership acquired as a consequence of liquidation or to reduce loss have to be sold by banks within 3 years.*
- *Obligation to record in the trading book.*
- *Assets can be sold without licence, which is required only if the legal form is altered.*

Principle 6: Banking supervisors must set minimum capital adequacy requirements for banks that reflect the risks that the bank undertakes, and must define the components of capital, bearing in mind its ability to absorb losses. For internationally active banks, these requirements must not be less than those established in the Basel Capital Accord.

Essential criteria

1. Laws or regulations require all banks to calculate and consistently maintain a minimum capital adequacy ratio. At least for internationally active banks, the definition of capital, method of calculation and the ratio required are not lower than those established in the Basel Capital Accord.

- *The basic principle concerning all criteria: implementation of development towards Basel II is in progress.*
- *The Supervision is scrutinising the development, and calculation of the solvency ratio on an ongoing basis (off-site) and through comprehensive audits, along with meeting statutory requirements concerning capital..*

2. The required capital ratio reflects the risk profile of individual banks, in particular credit risk and market risk. Both on-balance-sheet and off-balance-sheet risks are included.

- *In a systemic approach capital adequacy aligned to individual risk profiles is missing, the Supervision reviews whether the rate prescribed by law is met, while properly applying the risk weighting also determined by law.*
- *It is a general expectation that the capital should exceed the statutory minimum, with a view to operating risks, but not with respect to the individual risk profile of a given credit institution (in some exceptional cases the risk profile has been taken into account but this is not regular practice).*
- *Basel II lays an increased emphasis on the Supervision assessing the necessity of extra requirement.*

3. Laws or regulations, or the supervisor, define the components of capital, ensuring that emphasis is given to those elements of capital available to absorb losses.

- *Permanent off-site review of the composition of the regulatory capital and its calculation in line with the relevant legal regulations on the basis of data supplied, and in the course of the on-site comprehensive supervisory audit.*
- *Towards Basel II: in the process of implementation.*

4. Capital adequacy ratios are calculated and applied on a consolidated bank basis.

- *Off-site and on-site auditing (through comprehensive supervisory audit) of the consolidated calculation of capital adequacy takes place in line with the relevant legal regulations and the Supervision is managing any problem so identified, on a continuous basis.*
- *Statutory anomalies relating to loss of value (provisioning) undermine efficiency since the consolidation of financial enterprises entail different accounting requirements.*
- *The law on rating (qualification) has become outdated.*
- *Consolidated and un-consolidated requirements should have equal weights. At present the operation of the Supervision is focused on unconsolidated supervision.*
- *Consolidated data are supplied semi-annually, while it would be necessary on a quarterly basis; at the same time the Supervision does not even fully utilise the opportunities provided by semi-annual data supply.*

- *The risk of supervision is encountered primarily in the case of OTP.*

5. Laws or regulations clearly give the supervisor authority to take measures should a bank fall below the minimum capital ratio.

- *According to the provisions laid out in the Banking Act (Hpt.) the Supervision is obliged to take action when the solvency ratio drops below the statutory minimum (the type of action depends on the percentage by which it is below the minimum).*
- *The range of actions aiming at preventing diminishing needs to be extended and refined.*

6. Regular (at least semi-annually) reporting by banks to the supervisor is required on capital ratios and their components.

Monthly data supply is prescribed by law.

Additional criteria

1. For domestic, as well as internationally active banks, the definition of capital is broadly consistent with the Basel Capital Accord.

Legal regulation and the review of compliance with it equally applies to all credit institutions.

2. The supervisor clearly sets out the actions to be taken if capital falls below the minimum standards.

The actions to be taken in the case of violation of the statutory regulations concerning capital are clearly laid out and they are consistently applied by the Supervision.

3. The supervisor determines that banks have an internal process for assessing their overall capital adequacy in relation to their risk profile.

This is not required by the Supervision and its methodology is also missing and needs to be developed.

Development towards Basel II helps eliminate the problem.

4. Capital adequacy requirements take into account the conditions under which the banking system operates. Consequently, minimum requirements may be higher than the Basel Accord.

The rules on the calculation of the regulatory capital and the capital adequacy ratio have been adequately formulated in line with the domestic market conditions (weighing of real estates, handling of receivables from local governments), which will be altered as a consequence of Basel II.

5. Capital adequacy ratios are calculated on both a consolidated and a solo basis for the banking entities within a banking group.

- *Calculation takes place in line with the statutory requirements.*
- *The capital adequacy ratio of the owner of the group is missing.*
- *Capital allocation is missing*
- *See: CP 6.1.4.*

6. Laws or regulations stipulate a minimum absolute amount of capital for banks. (Reference document: “International convergence of capital measurement and capital standards” - July 1988)

Setting statutory minimum in line with Basel I.

Principle 7: An essential part of any supervisory system is the independent evaluation of a bank's policies, practices and procedures related to the granting of loans and making of investments and the ongoing management of the loan and investment portfolios.

Essential criteria

1. The supervisor requires, and periodically verifies, that prudent credit-granting and investment criteria, policies, practices, and procedures are approved, implemented, and periodically reviewed by bank management and boards of directors.

- *Compliance with the assumption and management of lending and investment risks is scrutinised by the Supervision in the course of the on-site comprehensive supervisory audit.*
- *The setting of credit risk policy and procedure is involved on the level of recommendation. Enforcement of the content and scope of the policy is not standardised.*

2. The supervisor requires, and periodically verifies, that such policies, practices and procedures include the establishment of an appropriate and properly controlled credit risk environment, including:

- a sound and well-documented credit granting and investment process;
- the maintenance of an appropriate credit administration, measurement and ongoing monitoring/reporting process (including asset grading/classification); and
- ensuring adequate controls over credit risk.
- *The above listed elements of the management of lending and investment risks are - in line with the statutory regulations and the contents of the recommendation - scrutinised by the Supervision through comprehensive supervisory audits.*
- *The provisions laid out in Decree 14/2001. PM have been surpassed by the practices of the trade, therefore it needs to be modified. At the same time, the supervisory requirement does no longer enforce the outdated practice in relation to credit institutions.*

3. The supervisor requires, and periodically verifies, that banks make credit decisions free of conflicting interests, on an arm's-length basis, and free from inappropriate pressure from outside parties.

- *Sub-section 7.1 lays down the foundation for the entire effectiveness of the audit of 7.3.*
- *The audit involves checking internal regulations and declarations on no conflicts of interests. Enforcement has not been standardised.*
- *In credit decisions the elimination of conflicts of interest and detrimental external pressures can be scrutinised predominantly only through one-off audits based on representative samples.*

4. The supervisor requires that a bank's credit assessment and granting standards are communicated to, at a minimum, all personnel involved in credit granting activities.

5. The supervisor has full access to information in the credit and investment portfolios and to the lending officers of the bank.

- *The Supervision has access to this information. The Supervision asks for fully detailed information in the course of the on-site audits and it is also possible to access the necessary information through continuous supervision.*

Additional criteria

1. The supervisor requires that the credit policy prescribes that major credits or investments, exceeding a certain amount or percentage of the bank's capital, are to be decided at a high managerial level of the bank. The same applies to credits or investments that are especially risky or otherwise not in line with the mainstream of the bank's activities.

This is met in the case of the amount limit of credit decisions, meeting the requirements laid out in the decree is checked in the course of the comprehensive supervisory audits.

2. The supervisor requires that banks have management information systems that provide essential details on the condition of the loan and investment portfolios.

- *This is reviewed by the Supervision through comprehensive supervisory audits.*

- *In the case of cooperatives management problems relating to IT hinder in some cases the proper operation of the MIS, the statutory foundations are missing in the case of cooperatives.*

3. The supervisor verifies that bank management monitors the total indebtedness of entities to which they extend credit. (Reference document: "Principles for the Management of Credit Risk" – July 1999.)

This is reviewed by the Supervision in the course of comprehensive supervisory audits.

Principle 8: Banking supervisors must be satisfied that banks establish and adhere to adequate policies, practices and procedures for evaluating the quality of assets and the adequacy of loan loss provisions and reserves.

Essential criteria

1. Either laws or regulations, or the supervisor, sets rules for the periodic review by banks of their individual credits, asset classification and provisioning, or the law/regulations establish a general framework and require banks to formulate specific policies for dealing with problem credits.

- *Compliance with the rules laid out in the MoF decree on rating and the accounting treatment of provisioning is checked by the Supervision through comprehensive supervisory audits.*
- *Problems of consolidated rating and provisioning.*

2. The classification and provisioning policies of a bank and their implementation are regularly reviewed by the supervisor or external auditors.

The Supervision reviews whether rating and provisioning is in line with the rules laid out in Decree 14/2001. PM (through comprehensive supervisory audits), the auditor checks this in the framework of the annual audit, in line with the relevant decree.

3. The system for classification and provisioning includes off-balance-sheet exposures.

This requirement is met.

4. The supervisor determines that banks have appropriate policies and procedures to ensure that loan loss provisions and write-offs reflect realistic repayment expectations.

- *This requirement is formally met.*
- *Anomalies of the MoF decree.*

5. The supervisor determines that banks have appropriate procedures and organisational resources for the ongoing oversight of problem credits and for collecting past due loans.

In the course of the comprehensive supervisory audit we check the existence and contents of the regulation (code) and the organisational requisites for the management of non-performing receivables.

6. The supervisor has the authority to require a bank to strengthen its lending practices, credit-granting standards, level of provisions and reserves, and overall financial strength if it deems the level of problem assets to be of concern.

Within the framework prescribed by Decree 14/2001 PM (MoF) we can prescribe tightening the lending regulations and re-categorisation in terms of rating or the booking of increased provisioning. The existing Decree of the MoF is outdated, it does not meet the Basel II requirements (e.g. rating - expected loss). Nevertheless, the Supervision has exercised its right specified in the criterion, as has been necessary.

7. The supervisor is informed on a periodic basis, and in relevant detail, concerning the classification of credits and assets and of provisioning.

- *Quarterly data supply, risk assessment.*
- *PET tables are analysed.*
- *IT problems undermine efficiency.*

8. The supervisor requires banks to have mechanisms in place for continually assessing the strength of guarantees and appraising the worth of collateral.

- *From the aspect of content, the supervisory requirements need to be improved in the cooperative sector (separation of valuation on a market basis and on exit value).
(retail, corporate division)*
- *Collateral security item registry systems are checked.*
- *In the case of mortgage banks there is no ongoing valuation but the task of registration is properly carried out.*

9. Loans are required to be identified as impaired when there is reason to believe that all amounts due (both principal and interest) will not be collected in accordance with the contractual terms of the loan agreement.

- *Compliance with the provisions of the decree (adequacy of internal regulation) is checked by the Supervision through comprehensive supervisory audits.*
- *The type of modification of the original contractual terms and conditions that results in a credit becoming 'non-performing' should be reviewed.*

10. The valuation of collateral is required to reflect the net realisable value.

This is not met as a consequence of the problem referred to in 8.1.8, or it is not demanded, e.g. in the case of mortgage banks.

Additional criteria

1. Loans are required to be classified when payments are contractually a minimum number of days in arrears (e.g., 30, 60, 90 days). Refinancing of loans that would otherwise fall into arrears does not lead to improved classifications for such loans.

- *Compliance with the provisions of the decree (adequacy of internal regulation) is checked by the Supervision through comprehensive supervisory audits.*
- *There is no established supervisory control for the 'substitution' of credits past due through refinancing, and there is no standardised interpretation.*

2. The supervisor requires that valuation, classification and provisioning for large credits are conducted on an individual item basis. (Reference document: "Sound Practices for Loan Accounting and Disclosure" – July 1999.)

Individual rating and determination of value loss/specific provision is required above a limit amount specified in the internal regulation.

Principle 9: Banking supervisors must be satisfied that banks have management information systems that enable management to identify concentrations within the portfolio and supervisors must set prudential limits to restrict bank exposures to single borrowers or groups of related borrowers.

Essential criteria

1. A “closely related group” is explicitly defined to reflect actual risk exposure. The supervisor has discretion, which may be prescribed by law, in interpreting this definition on a case-by-case basis.

- *The Supervision has no discretionary right concerning individual interpretation of the concept of customer group.*
- *The identification of a customer group takes a lot of care (e.g. interpreting the criteria of close relative, the same household), and the Supervision exercises this right in a cautious way, in some cases with success.*

2. Laws or regulations, or the supervisor, set prudent limits on large exposures to a single borrower or closely related group of borrowers. “Exposures” include all claims and transactions, on-balance sheet as well as off-balance sheet.

Compliance with statutory limitations is regularly checked by the Supervision.

3. The supervisor verifies that banks have management information systems that enable management to identify on a timely basis concentrations (including large individual exposures) within the portfolio on a solo and consolidated basis.

- *The Supervision checks reports prepared for management in the course of reviewing the MIS.*
- *The assessment of the contents of the MIS, tracing feedbacks and the method of supervisory evaluation of the consolidated MIS needs to be improved.*
- *The Supervision’s options for action concerning deficiencies of the MIS - often originating from IT related management problems (cooperatives!) are limited.*

4. The supervisor verifies that bank management monitors these limits and that they are not exceeded on a solo and consolidated basis.

See the above point.

5. The supervisor regularly obtains information that enables concentrations within a bank’s credit portfolio, including sectoral and geographic exposures, to be reviewed.

- *The information contents of the data supplied are not sufficient for a comprehensive assessment of concentrations..*
- *The Supervision does not request data supplies on sectoral concentration, though it is reviewed on-site.*

Additional criteria

1. Banks are required to adhere to the following definitions:

- 10 percent or more of a bank’s capital is defined as a large exposure;
- 25 percent of a bank’s capital is the limit for an individual large exposure to a private sector non-bank borrower or a closely related group of borrowers.

Minor deviations from these limits may be acceptable, especially if explicitly temporary or related to very small or specialised banks. (Reference document: “*Measuring and controlling large credit exposures*” – January 1991.)

This requirement is met.

Principle 10: In order to prevent abuses arising from connected lending, banking supervisors must have in place requirements that banks lend to related companies and individuals on an arm's-length basis, that such extensions of credit are effectively monitored, and that other appropriate steps are taken to control or mitigate the risks.

Essential criteria

1. A comprehensive definition of “connected or related parties” exists in law and/or regulation. The supervisor has discretion, which may be prescribed in law, to make judgements about the existence of connections between the bank and other parties.

The definition is laid out by law.

2. Laws and regulations exist that exposures to connected or related parties may not be extended on more favourable terms (i.e., for credit assessment, tenor, interest rates, amortisation schedules, requirement for collateral) than corresponding loans to nonrelated counterparties⁷.

- *The legal regulations provide for prohibiting more favourable terms and conditions in an implicit way.*
- *Prohibiting the application of more favourable terms and conditions is not included in the supervisory approach.*
- *(According to Decree 14/2001 PM banks may not give a better rating to such customers in their customer rating practices.)*

3. The supervisor requires that transactions with connected or related parties exceeding specified amounts or otherwise posing special risks are subject to approval by the bank's board of directors.

- *The Banking Act prescribes the conditions, Board of Directors decision with a higher than 2/3 majority.*
- *The requirements of corporate governance concerning independent external members are not adequate, consequently, in terms of content, the requirement of independent decision making is sometimes not met.*
- *It is contained in the programme of competent supervisory audits - with the above deficiency.*

4. The supervisor requires that banks have procedures in place to prevent persons benefiting from the loan being part of the preparation of the loan assessment or of the decision itself.

- *The Supervision checks compliance with the relevant provisions contained in the MoF decree and whether it is laid out in the internal regulations (e.g. participation of person carrying out the tasks of collateral evaluation).*
- *At the same time the effectiveness of the work of the Supervision is questioned by the problem referred to in 10.1.2 and 10.1.3.*
- *The effectiveness of the prohibition of obtaining personal gain should be improved.*

5. Laws or regulations set, or the supervisor has the mandate to set on a general or caseby- case basis, limits for loans to connected and related parties, to deduct such lending from capital when assessing capital adequacy or to require collateralisation of such loans.

- *Keeping within the limit specified in the Banking Act and deduction of excess over limit from the regulatory capital is checked by the Supervision in the course of the comprehensive supervisory audits.*

- *In the case of prescribing limits and subtracting receivables over limit from capital is OK, there is no way to demand extra collateral, however, it is possible to demand rating and booking provisions, which lead to the same result in essence.*
- *Article 80 (1) g) of the Banking Act gives exemption from limits concerning associated credits, within associated credits this type of credits have a predominant weight on a sectoral level.*

6. The supervisor requires banks to have information systems to identify individual loans to connected and related parties as well as the total amount of such loans, and to monitor them through an independent credit administration process.

The Supervision reviews keeping separated registry as prescribed by law.

7. The supervisor obtains and reviews information on aggregate lending to connected and related parties.

Additional criteria

1. The definition of “connected or related parties” established in law and/or regulation is broad and, generally, includes affiliated companies, significant shareholders, board members, senior management, key staff as well as close family members, corresponding persons in affiliated companies, and companies controlled by insiders and shareholders.

They are broad enough. In disputed cases the Supervision has a discretionary right which it exercises when necessary.

2. There are limits on aggregate exposures to connected and related parties that are at least as strict as those for single borrowers, groups or related borrowers.

- *As a general rule, internal credits are prohibited, internal regulation permits only preferential packages or certain standard products, along with a stricter decision making process and registration.*
- *In respect of associated credits there is a tighter limit than in the case of other large risk assumption, which is, however removed by Article 80 (1) g) of the Banking Act without imposing a quality criterion.*

Principle 11: Banking supervisors must be satisfied that banks have adequate policies and procedures for identifying, monitoring and controlling country risk and transfer risk in their international lending and investment activities, and for maintaining appropriate reserves against such risks.

Essential criteria

1. The supervisor determines that a bank's policies and procedures give due regard to the identification, monitoring and control of country risk and transfer risk. Exposures are identified and monitored on an individual country basis (in addition to the endborrower/ end-counterparty basis). Banks are required to monitor and evaluate developments in country risk and in transfer risk and apply appropriate countermeasures.

- *The Supervision reviews country risk and its capital requirement in view of the requirements laid out in law and recommendation. Institutions exposed to country risk (e.g. Eximbank) have specific regulations on the establishment and the mode of management of country risks.*
- *The regulation will be altered in relation to Basel II.*

2. The supervisor verifies that banks have information systems, risk management systems and internal control systems to comply with those policies.

On-site audits cover the documentation of country limit proposals of risk management and its correspondence to the contents of regulations. The annual work plan of the internal audit function and its completion are also reviewed. The country risk limits are typically reviewed annually.

3. There is supervisory oversight of the setting of appropriate provisions against country risk and transfer risk. There are different international practices which are all acceptable as long as they lead to reasonable, risk-related, results. These include, *inter alia*:

- The supervisor (or some other official authority) decides on appropriate minimum provisioning by setting fixed percentages for exposures to each country.
- The supervisor (or some other official authority) sets percentage intervals for each country and the banks may decide, within these intervals, which provisioning to apply for the individual exposures.
- The bank itself (or some other body such as the national bankers' association) sets percentages or guidelines or even decides for each individual loan on the appropriate provisioning. The provisioning will then be judged by the external auditor and/or by the supervisor.

The net value of the individually rated items is the basis of the calculation of the country risk limit.

According to Decree 16/2001 PM the country risk limit may be exceeded but the amount in excess is to be covered by capital. No provision needs to be set aside within the limit.

4. The supervisor obtains and reviews sufficient information on a timely basis on the country risk/transfer risk of individual banks. (Reference document: "Management of banks' international lending" – March 1982.)

This appears in the quarterly supervisory data supply in table 9B by country, which is detailed sufficiently. It also includes the value of insurance and reinsurance coverage as well.

Principle 12: Banking supervisors must be satisfied that banks have in place systems that accurately measure, monitor and adequately control market risks; supervisors should have powers to impose specific limits and /or a specific capital charge on market risk exposures, if warranted.

Essential criteria

1. The supervisor determines that a bank has suitable policies and procedures related to the identification, measuring, monitoring and control of market risk.

- *Market risks - these are being introduced in accordance with Basel II and EU regulation; this applies to the entire CP.*
- *Article 5 of Decree 14/2001. PM provides for the contents of the risk assumption regulation. The requirements laid out here clearly apply to controlling the counterparty risk/lending risk, but they do not prescribe direct requirements for the identification, measuring, monitoring or management of market risks.*
- *In the case of the trading portfolio the relevant regulation (Kkr.) properly regulate the identification and measurement of market risks and the establishment of the capital requirement associated with the risk but in the case of the banking book the statutory background concerning the management of market risks is incomplete.*
- *The practice is, nevertheless, reassuring, the majority of the banks apply adequate risk management rules even without statutory requirements (as is in their own interests). No. 2;/2000 HFSA recommendation applies to the whole range of market risks-*

2. The supervisor determines that the bank has set appropriate limits for various market risks, including their foreign exchange business.

- *The open position limit (maximum 30 % of the regulatory capital) is no longer in effect, however, capital is to be set aside for the part exceeding 2 % of the regulatory capital.*
- *This issue can also be regarded to have been properly dealt with in an indirect way (by prescribing identification, measuring and setting capital requirement), and only in regard to the trading portfolio and the foreign exchange rate risk. Practices are nevertheless properly arranged, for this is checked by audits and noted in the reports.*

3. The supervisor has the power to impose a specific capital charge and/or specific limits on market risk exposures, including their foreign exchange business.

The Kkr. prescribes setting capital requirement for market risks in relation to the trading portfolio and foreign exchange rate risks. The foreign exchange rate risk of the share portfolio contained in the banking book is managed indirectly by the investment limits. However, at present there is no statutory limit on the interest rate risk that may be assumed by a bank on the portfolios of deposit/bond liability - credit/bond portfolio in the banking book. The Supervision points out deficiencies in its audit reports, but it does not oblige institutions to keep their risks below a certain limit. Where necessary, however, the Supervision may prescribe additional capital requirement.

4. The supervisor verifies that banks have information systems, risk management systems and internal control systems to comply with those policies, and verifies that any limits (either internal or imposed by the supervisor) are adhered to.

The audits provide for checking existence and suitability of the systems, along with whether the systems are properly coordinated.

5. The supervisor satisfies itself that there are systems and controls in place to ensure that all transactions are captured on a timely basis, and that the banks' positions are revalued frequently, using reliable and prudent market data.

- *Open positions are revalued by institutions every day.*
- *On-site audits provide a suitable framework for this.*

6. The supervisor determines that banks perform scenario analysis, stress testing and contingency planning, as appropriate, and periodic validation or testing of the systems used to measure market risk.

- *In the case of the liquidity risk preparing contingency plan is prescribed by Article 89 of the Banking Act. This is checked and evaluated in the course of the on-site audits. A Recommendation discusses interest rate, foreign exchange and share price risks.*
- *With respect to share portfolios rated as risky the banks typically produce scenario analyses, stress tests, VAR and BPV analyses. These and their compliance with the internal regulations are checked by the Supervision in the course of the on-site audits, taking the necessary actions.*

7. The supervisor has the expertise needed to monitor the actual level of complexity in the market activities of banks.

- *The Supervision does have the necessary expertise for assessing the banks' market activities, the risks assumed in such activities and the systems operated to manage the risks.*
- *The available human resources are short, the employees capable of supervising market risks are working in several areas. The Supervision is running a significant HR risk, which could be mitigated by concentrating its forces.*

Additional criteria

1. Either through on-site work, or through internal or independent external experts, the supervisor determines that senior management understands the market risks inherent in the business lines/products traded and that it regularly reviews and understands the implications (and limitations) of the risk management information that they receive.

- *In the course of an on-site audit the supervisory auditor evaluates the relevant responsiveness and capability of the managers by reviewing the committee records, the contents of the risk reports and the lessons drawn from interviews.*
- *Standardisation is typically missing from the criteria, along with a HR management aspect.*
- *In relation to on-site audits, see also CP 16.1.1.*

2. The supervisor reviews the quality of management information and forms an opinion on whether the management information is sufficient to reflect properly the banks' position and exposure to market risk. In particular, the supervisor reviews the assumptions management has used in their stress testing scenarios, and the banks' contingency plans for dealing with such conditions.

In the course of the on-site audit the supervisory auditor evaluates the MIS based on his own findings and by comparing the bank's internal records to data supplied to the NBH and to the HFSA.

3. The supervisor who does not have access to the adequate skills and capacity does not allow banks to determine their regulatory capital requirements based on sophisticated models, such as

VaR. (Reference document: “Amendment to the Capital Accord to incorporate market risks” - January 1996.)

Principle 13: Banking supervisors must be satisfied that banks have in place a comprehensive risk management process (including appropriate board and senior management oversight) to identify, measure, monitor and control all other material risks and, where appropriate, to hold capital against these risks.

Essential criteria

1. The supervisor requires individual banks to have in place comprehensive risk management processes to identify, measure, monitor and control material risks. These processes are adequate for the size and nature of the activities of the bank and are periodically adjusted in light of the changing risk profile of the bank and external market developments. These processes include appropriate board and senior management oversight.

- *The procedures of risk management are regularly audited by the Supervision.*
- *Evaluation can be improved from the aspect of the owner's supervision of changing risk profiles and external market changes.*
- *The audit also includes checking preparation for Basel II.*
- *Some banks are operating rudimentary risk management practices and their owners are not making efforts to improve this. They cannot always create adequate systems even on the basis of the No. 3/2000 Supervisory Recommendation; more consistent enforcement of measures.*

2. The supervisor determines that the risk management processes address liquidity risk, interest rate risk, and operational risk as well as all other risks, including those risks covered in other Principles (e.g., credit and market risk). These would include:

- Liquidity: good management information systems, central liquidity control, analysis of net funding requirements under alternative scenarios, diversification of funding sources, stress testing and contingency planning. Liquidity management should separately address domestic and foreign currencies.
- Interest rate risk: good management information systems and stress testing.
- Operational risk: internal audit, procedures to counter fraud, sound business resumption plans, procedures covering major system modifications and preparation for significant changes in the business environment.
- *The audit usually covers: vulnerability, volatility, short term liquidity management (handling nostro accounts, meeting reserving obligations), preparation for liquidity contingency situations and development of contingency plans and*
- *the adequate management of the interest rate risk in the banking book (repricing GAP analysis, existence of stress tests) as well,*
- *The Supervision reviews operating risks primarily from the aspect of IT, fraud, litigation and money laundering.*
- *The management of liquidity risks is simplified in the case of small banks, not all banks produce contingency plans.*

3. The supervisor issues standards related to such topics as liquidity risk, interest rate risk, foreign exchange risk and operational risk.

4. The supervisor sets liquidity guidelines for banks, which include allowing only truly liquid assets to be treated as such, and takes into consideration undrawn commitments and other off-balance- sheet liabilities, as well as existing on-balance-sheet liabilities.

The enforcement of the Banking Supervision's regulation on liquidity is questionable, the enforcement of the recommendation is not consistent.

5. The supervisor determines that limits and procedures are communicated to the appropriate personnel and primary responsibility for adhering to limits and procedures is placed with the relevant business units.

- *This is ascertained in the course of the audits.*
- *Experience shows different levels of knowledge of limits and procedures. In some cases the internal regulations do not match the relevant legal regulations.*

6. The supervisor periodically verifies that these risk management processes, capital requirements, liquidity guidelines and qualitative standards are being adhered to in practice.

Additional criteria

1. The supervisor has the authority to require a bank to hold capital against risks in addition to credit and market risk.

The Supervision has a right but owing to content related uncertainties of other - primarily quality - risks, it is only carefully exercised.

2. The supervisor encourages banks to include a statement on their risk management policies and procedures in their publicly available accounts.

3. Supervisors obtain sufficient information to enable them to identify those institutions carrying out significant foreign currency liquidity transformation.

- *Foreign exchange liquidity transformation is identified in the course of on-site audits, the central bank is traditionally paying more attention to liquidity risks.*
- *Payment transactions - particularly foreign - are not paid sufficient attention to (the Supervision focuses more on portfolios, and not at all on transactions). So far it was accessed by the NBH, they carried out this task: this is being changed.*

4. The supervisor determines that, where a bank conducts its business in multiple currencies, management understands and addresses the particular issues this involves. Foreign currency liquidity strategy is separately stress-tested and the results of such tests are a factor in determining the appropriateness of mismatches. (Reference documents: "Principles for the management of interest rate risk" – September 1997 and "A framework for measuring and managing liquidity" – September 1992.)

See the above point.

Principle 14: Banking supervisors must determine that banks have in place internal controls that are adequate for the nature and scale of their business. These should include clear arrangements for delegating authority and responsibility; separation of the functions that involve committing the bank, paying away its funds, and accounting for its assets and liabilities; reconciliation of these processes; safeguarding its assets; and appropriate independent internal or external audit and compliance functions to test adherence to these controls as well as applicable laws and regulations.

Essential criteria

1. Corporate or banking laws identify the responsibilities of the board of directors with respect to corporate governance principles to ensure that there is effective control over every aspect of risk management.

- *Lack of coordination between responsibility, scope of power and accountability (different operation of banks with Prussian and those with Anglo-Saxon backgrounds).*
- *Corporate governance needs regulatory, supervision methodology review, development and training.*

2. The supervisor determines that banks have in place internal controls that are adequate for the nature and scale of their business. These controls are the responsibility of the board of directors and deal with organisational structure, accounting procedures, checks and balances and the safeguarding of assets and investments. More specifically, these address:

- Organisational structure: definitions of duties and responsibilities including clear delegation of authority (for example, clear loan approval limits), decision-making procedures, separation of critical functions (for example, business origination, payments, reconciliation, risk management, accounting, audit and compliance).
- Accounting procedures: reconciliation of accounts, control lists, information for management.
- Checks and balances (or “four eyes principles”): segregation of duties, crosschecking, dual control of assets, double signatures.
- Safeguarding assets and investments: including physical control.
- *The auditing of responsibilities and scopes of competence of bodies needs to be improved, a prerequisite for which is clearer definition of such roles in the Banking Act.*
- *The supervision of the separation of scopes of duties and functions could be improved by strengthening the auditing of processes.*

3. To achieve a strong control environment, the supervisor requires that the board of directors and senior management of a bank understand the underlying risks in their business and are both committed to, and legally responsible for, the control environment. Consequently, the supervisor evaluates the composition of the board of directors and senior management to determine that they have the necessary skills for the size and nature of the activities of the bank and can address the changing risk profile of the bank and external market developments. The supervisor has the legal authority to require changes in the composition of the board and management in order to satisfy these criteria.

- *The Supervision has formal authorisation but that is not aligned to this requirement in the desired way.*
- *Methodology for evaluating expertise is missing.*

- *The auditing of responsibilities and scopes of competence of bodies (delegation, separation of functions) needs to be improved.*
- *For lack of supervisory methodology the qualifications, fitness, expertise and managerial suitability as well as commitment (attitude) of the members of the board of directors, the supervisory board and top management are not adequately assessed.*
- *It is regulated and functioning in the area of IT audits in accordance with the COBIT method.*

4. The supervisor determines that there is an appropriate balance in the skills and resources of the back office and control functions relative to the front office/business origination.

A general view is formed in the course of the audits. However, there is no such specific audit criterion. Any glaring inequilibrium is criticised by the Supervision.

5. The supervisor determines that banks have an appropriate audit function charged with (a) ensuring that policies and procedures are complied with and (b) reviewing whether the existing policies, practises and controls remain sufficient and appropriate for the bank's business. The supervisor determines that the audit function:

- has unfettered access to all the bank's business lines and support departments;
- has appropriate independence, including reporting lines to the board of directors and status within the bank to ensure that senior management reacts to and acts upon its recommendations;
- has sufficient resources, and staff that are suitably trained and have relevant experience to understand and evaluate the business they are auditing;
- employs a methodology that identifies the key risks run by the bank and allocates its resources accordingly.

6. The supervisor has access to the reports of the audit function.

Additional criteria

1. In those countries with a unicameral board structure (as opposed to a bicameral structure with a supervisory board and a management board), the supervisor requires the board of directors to include a number of experienced non-executive directors.

This is not applicable in Hungary.

2. The supervisor requires the internal audit function to report to an Audit Committee.

The Supervision demands that the internal audit organisation reports to an independent organisation unit which may be the Audit Committee or the Supervisory Board, depending on the governance structure.

Setting up an audit committee is not mandatory. In the case of banks following typically German (Prussian) law the SB functions as a governing body..

3. In those countries with a unicameral board structure, the supervisor requires the Audit Committee to include experienced non-executive directors. (Reference document: "Framework for internal control systems in banking organisations" – September 1998.)

This is not applicable in Hungary.

Principle 15: Banking supervisors must determine that banks have adequate policies, practices and procedures in place, including strict “know-your-customer” rules, that promote high ethical and professional standards in the financial sector and prevent the bank being used, intentionally or unintentionally, by criminal elements.

Essential criteria

1. The supervisor determines that banks have in place adequate policies, practices and procedures that promote high ethical and professional standards and prevent the bank from being used, intentionally or unintentionally, by criminal elements. This includes the prevention and detection of criminal activity or fraud, and reporting of such suspected activities to the appropriate authorities.

Having and complying with a code of conduct is not a requirement, human risks and management are not supervised (except for money laundering). Demanding full compliance with consumer protection rules of the EU - that have been integrated in the Banking Act.

- *Transaction monitoring,*
- *Review of continuous vacationing in the case of cooperatives as well,*
- *Code of conduct of the banking federation, for banks,*
- *Stating total loan charge and standard deposit interest rate.*

2. The supervisor determines that banks have documented and enforced policies for identification of customers and those acting on their behalf as part of their anti-moneylaundering program. There are clear rules on what records must be kept on customer identification and individual transactions and the retention period.

3. The supervisor determines that banks have formal procedures to recognise potentially suspicious transactions. These might include additional authorisation for large cash (or similar) deposits or withdrawals and special procedures for unusual transactions.

4. The supervisor determines that banks appoint a senior officer with explicit responsibility for ensuring that the bank’s policies and procedures are, at a minimum, in accordance with local statutory and regulatory anti-money laundering requirements.

5. The supervisor determines that banks have clear procedures, communicated to all personnel, for staff to report suspicious transactions to the dedicated senior officer responsible for anti-money laundering compliance.

6. The supervisor determines that banks have established lines of communication both to management and to an internal security (guardian) function for reporting problems.

There are reports relating to money laundering, this requirement is not met in general with respect to the other elements of operating risks.

7. In addition to reporting to the appropriate criminal authorities, banks report to the supervisor suspicious activities and incidents of fraud material to the safety, soundness or reputation of the bank.

8. Laws, regulations and/or banks' policies ensure that a member of staff who reports suspicious transactions in good faith to the dedicated senior officer, internal security function, or directly to the relevant authority cannot be held liable.

9. The supervisor periodically checks that banks' money laundering controls and their systems for preventing, identifying and reporting fraud are sufficient. The supervisor has adequate enforcement powers (regulatory and/or criminal prosecution) to take action against a bank that does not comply with its anti-money laundering obligations.

- *The reporting table contained in the quarterly data supply to the Supervision is being modified.*
- *The comprehensive audit and the risk assessment both cover cases of money laundering and fraud but these two topics are not sufficiently emphasised.*

10. The supervisor is able, directly or indirectly, to share with domestic and foreign financial sector supervisory authorities information related to suspected or actual criminal activities.

11. The supervisor determines that banks have a policy statement on ethics and professional behaviour that is clearly communicated to all staff.

No Code of Conduct is currently demanded by the Supervision.

Additional criteria

1. The laws and/or regulations embody international sound practices, such as compliance with the relevant forty Financial Action Task Force Recommendations issued in 1990 (revised 1996).

2. The supervisor determines that bank staff is adequately trained on money laundering detection and prevention.

3. The supervisor has the legal obligation to inform the relevant criminal authorities of any suspicious transactions.

4. The supervisor is able, directly or indirectly, to share with relevant judicial authorities information related to suspected or actual criminal activities.

5. If not performed by another agency, the supervisor has in-house resources with specialist expertise on financial fraud and anti-money laundering obligations. (Reference document: "Prevention of criminal use of the banking system for the purpose of money-laundering" – December 1988.)

Obligations concerning the impeding of money laundering, i.e. prevention. We do not have a sufficient number of experts on this.

Principle 16: An effective banking supervisory system should consist of some form of both on-site and off-site supervision.

(Note: this Principle should be considered in conjunction with Principles 17 through 20.)

Essential criteria

1. Banking supervision requires an in-depth understanding, periodic analysis and evaluation of individual banks, focussing on safety and soundness, based on meetings with management and a combination of both on-site and off-site supervision. The supervisor has a framework that (1) uses on-site work (conducted either by own staff or through the work of external auditors) as a primary tool to:

- provide independent verification that adequate corporate governance (including risk management and internal control systems) exists at individual banks;
- determine that information provided by banks is reliable;
- obtain additional information needed to assess the condition of the bank.
- *The Supervision is auditing risk management and the internal audit systems in the framework of both on-site and the off-site supervisory audits.*
- *At present, members of the management of an institution are met on an ad hoc basis.*
- *In the course of on-site audits the Supervision checks the reliability of the Bank's data supplies and other reports produced by the Bank (e.g. MIS, reports to owners, data supplied for parent bank under instruction by foreign supervision) and other reports (such as annual audited report, flash reports).*
- *On-site audit is carried out by the Supervision in accordance with the Manual of the audit of credit institutions - currently reviewed - and the audit work programme annexed to the Manual. Our work is documented in special work sheets elaborated for the various themes, and this is aided by questionnaires posted to the institutions in advance.*

2. And (2) uses off-site work as a primary tool to:

- review and analyse the financial condition of individual banks using prudential reports, statistical returns and other appropriate information, including publicly available information;
- monitor trends and developments for the banking sector as a whole.
- *In the course of the off-site audit the Supervision reviews the Bank's main ratios monthly, on the basis of the mandatory data supplies, paying special attention to the trends in the risk-weighted asset value and the capital adequacy ratio (by assessing the time series flash report).*
- *Risk assessment is carried out quarterly, containing objective and subjective elements, including a review of personal, operating and business risks as well. This involves analysis of the values of and trends in the given bank's results and indicators, along with peer group and sector comparisons.*
- *The strategy submitted by the bank, the annual business policy guidelines, the audited annual reports, business reports and flash reports are reviewed.*
- *The development of the banking sector is analysed once every six months.*
- *Sector analyses are carried out quarterly, as part of the risk assessment exercise.*
- *A review of the risk assessment system is underway.*
- *Preparation of consolidated risk assessment is in progress.*
- *Problems of the data supply system (the data structure is too complicated and too deep, a significant proportion of data are never used).*
- *Deficiencies of the KIR (Excel spreadsheets, ratios produced without control, deficiencies of procedural regime etc.)*

- *In the case of universal banks the risks of investment service provision are not integrated in the system of risk assessment. This is checked on-site.*

3. The supervisor checks for compliance with prudential regulations and other legal requirements through on-site and off-site work.

- *Meeting the requirements laid out in the Banking Act, in the Capital Market Act and in other legal regulations are checked in both on-site and off-site audit and surveillance, paying special attention to prudential rules.*
- *A number of tables in the data supplies provided by credit institutions review meeting requirements.*
- *Alarm indicators.*

4. The appropriate mix of on-site and off-site supervision is determined by the particular conditions and circumstances of the country. In any event, the framework integrates the two functions so as to maximise the synergy and avoid supervisory gaps.

- *In assessing the activities of a Bank the Supervision applies a combination of off-site and on-site surveillance and audit together.*
- *The on-site audits are also carried out on the basis of risks.*
- *The risks of activities are back-tested in the course of on-site audits..*
- *The methodology of off-site surveillance needs improvement.*

Additional criteria

1. The supervisor has procedures in place to assess the effectiveness of on-site and off-site functions, and to address any weaknesses that are identified.

The audit policy, the procedural regime of the planning and implementing prudential supervisory audits and the on-site audit manual, the relevant procedural regime and practice are reviewed on an ongoing basis.

The ratios of risk assessment, however, are being reviewed now for the first time.

2. The supervisor has the right to access copies of reports submitted to the board by both internal and external auditors.

In his on-site and off-site work alike, the supervisor uses the contents of the supervisory board and board of directors reports, along with those contained in the report on the annual audit, the management letter and the supplementary report.

3. The supervisor has a methodology for determining and assessing the nature, importance and scope of the risks to which individual banks are exposed, including the business focus, the risk profile and the internal control environment. Off-site and on-site work is prioritised based on the results of that assessment.

- *The Supervision has a published on-site audit policy containing the principles and methods relating to the supervisory audit.*
- *The audit manual contains the methodology by theme, along with the general aspects of auditing, by risk category as well as the work sheets used during an audit and the questionnaires sent to banks in advance (IT, management of assets and liabilities, controlling, HR, internal audit). In the course of the on-site audit we prepare a bank-specific audit work programme (based on the conceptual summary).*

- *In relation to off-site surveillance a quarterly risk assessment is produced for every bank containing subjective and objective elements alike, for the various risk types. (the assessment of personal, business and operating risks, in five risk assessment categories).*
- *The risk based approach has not yet fully evolved in practice.*
- *The analysis of market processes, macro-prudential analyses are not integrated in supervisory activities.*

4. The supervisor is legally required to treat as confidential information received as part of the supervisory process. However, the supervisor is given powers under the law to disclose information in certain defined circumstances. The law prevents disclosure of confidential information unless the supervisor is satisfied that it will be held confidential by the recipient, or unless disclosure is otherwise required by law.

The supervisory auditor treats information acquired on-site or off-site confidentially, as prescribed by the relevant legal regulations.

5. The supervisor is able to reasonably place reliance on internal audit work that has been competently and independently performed.

In relation to on-site audits we review reports produced by the internal audit function, treating their contents with due care and criticism and use them only if their quality meets the standards.

Principle 17: Banking supervisors must have regular contact with bank management and a thorough understanding of the institution's operations.

Essential criteria

1. Based on the risk profile of individual banks, the supervisor has a programme of regular meetings with senior and middle management (including the board, non-executive directors and heads of individual units) to discuss operational matters such as strategy, group structure, corporate governance, performance, capital adequacy, liquidity, asset quality, risk management systems etc.

Once every two years, as part of the comprehensive on-site audit, the activities, performance, strategy, risk management systems of the bank and the group, is discussed with the member of the management group, the board of directors and middle managers. There is no additional schedule laid out in any specific programme, but meetings are organised upon reviewing the monthly data supplies, in relation to the quarterly risk assessment and in relation to certain specific issues - e.g. bank group.

2. The supervisor has a thorough understanding of the activities of its banks. This is accomplished through a combination of off-site surveillance, on-site reviews and regular meetings.

Within the framework of on-site and off-site audits and surveillance the supervisory institution is fully covered and is assessed according to risk categories/criteria. The on-site audit reports also contain the rating of the given area (personal, operating, business risks) by risk category.

The supervisory auditor is in contact with the bank's contact person, and with management and other top or medium managers as required.

In the framework of off-site surveillance through annual reports, data supplies, quarterly risk assessments and from other sources of information (press, Internet, television) we have adequate information.

3. The supervisor requires banks to notify it of any substantive changes in their activities or any material adverse developments, including breach of legal and prudential requirements.

- The supervisory auditors keep permanent contacts with the bank's contact persons and their compliance officers, keeping one another informed.

- The Supervision regularly asks banks to submit records of board of directors and supervisory board meetings, however, these contain rather heterogeneous details.

4. As part of the licensing process, and on an on-going basis during routine supervision, the supervisor considers the quality of management.

- Both the licensing process and permanent (off-site and on-site) supervision involves assessment of the members of management (personal risks).

- This works on an ad hoc and informal basis in the licensing process but its way or method has not been documented.

Principle 18: Banking supervisors must have a means of collecting, reviewing and analysing prudential reports and statistical returns from banks on a solo and consolidated basis.

Essential criteria

1. The supervisor has the legal authority to require banking organisations to submit information, on both a solo and consolidated basis, on their financial condition and performance, at regular intervals. These reports provide data on matters such as on- and off-balance sheet assets and liabilities, profit and loss, capital adequacy, liquidity, large exposures, loan loss provisioning, market risk and deposit sources.

- *Data is supplied on the basis of the relevant Government Decree and MoF Decree (Article 235 of the Banking Act).*
- *The Supervision can make proposals and comments.*
- *The Supervision asks banks for monthly, quarterly and annual data on a mandatory basis.*
- *The decree on data supply is issued by the MoF and not by the Supervision. The proposed content is not materially altered by the MoF, but disclosure is slow and late in the majority of cases.*
- *The distribution of powers established in regulation could properly function between the Supervision and the MoF but it is chronically wrong. So the situation could be improved by the Supervision having a right to adopt decrees.*

2. Laws and regulations establish, or the supervisor has the authority to establish, the principles and norms regarding the consolidation of accounts as well as the accounting techniques to be used.

- *Regulating of accounting is a task for the Ministry of Finance, the Supervision can comment and make proposals on decrees and laws which is usually disregarded by the legislator.*
- *Problems of consolidated data supply and accounting.*

3. The supervisor has a means of enforcing compliance with the requirements that the information be submitted on a timely and accurate basis. The supervisor determines that the appropriate level of senior management is responsible for the accuracy of supervisory returns, can impose penalties for deliberate mis-reporting and persistent errors, and can require that inaccurate information be amended.

- *The Supervision prescribes the deadline for the submission of data in the piece of legislation prescribing data supply, ordering in the same piece of legislation that the person in charge of data supply be specified. Sanctions on submitting data beyond the deadline or on submitting wrong data are prescribed by the Banking Act.*
- *The Supervision usually issues instructions, warning or initiates imposing a fine.*

4. The information that is required to be submitted includes standardised prudential and statistical reports, and detailed balance sheets and income statements, as well as supporting schedules that provide details concerning on and off balance sheet activities and on reserves included in capital. Inclusion of data on loan classification and provisioning is also required.

These are contained in mandatory data supply.

5. The supervisor has the authority to request and receive any relevant information from banks, as well as any of their related companies, irrespective of their activities, where the supervisor

believes that it is material to the financial situation of the bank or the assessment of the risks of the bank.

- *The Supervision may ask both the bank and other institutions related to the bank for information.*
- *The Supervision regularly exercises this right.*

6. The supervisor has an analytical framework that uses the statistical and prudential information for the ongoing monitoring of the condition and performance of individual banks. The results are also used as a component of on-site supervision planning. This requires that the supervisor has an adequate information system.

- *The Supervision has an information system (KIR).*
- *The Supervision applies the risk assessment system for quarterly evaluations. Objective and subjective elements .*
- *The so-called PET tables for banks have been produced to support institutional analyses.*
- *The framework is available, however, improvement is required in the related procedures and methodology and in the existing but unexploited analysis and technical options*
- *The findings of individual risk assessment are taken into account in planning an audit.*
- *During carrying out this self-assessment the requirement of the mandatory two year audit cycle requirement was eliminated, thus the audit cycle can be more effectively aligned to the level of risks.*
- *The Supervision prepares risk-based annual audit plans without reserves. The plan is usually adjusted but no rolling plan is prepared.*
- *A general problem of resource allocation.*

7. In order to make meaningful comparisons between banking organisations, the supervisor collects data from all banks and all other relevant entities within a banking organisation on a comparable basis and related to the same dates (stock data) and periods (flow data).

This one is all right.

8. The supervisor collects data from banks at a frequency (e.g., monthly, quarterly and annually) commensurate with the nature of the information requested, and the size, activities and risk profile of the individual bank.

Yes.

Principle 19: Banking supervisors must have a means of independent validation of supervisory information either through on-site examinations or use of external auditors.

Essential criteria

1. The supervisor has in place a coherent process for planning and executing on-site visits, using either in-house examiners, or making use of the work of external auditors, as appropriate. There are policies and procedures in place to ensure that examinations are conducted on a thorough and consistent basis with clear responsibilities, objectives and outputs. The supervisor holds meetings with banks and their auditors to discuss the results of work by the external auditors and to agree on the responsibilities for corrective work.

- *On-site audits are planned on an annual level, carried out by the Supervision through a fixed procedure, according to an established methodology. This is now being changed (see also the evaluation of CP 16.1.1)*
- *Planning is influenced by the Banking Act which was amended during the self-assessment.*
- *Risk based supervision methodology and practice has to be developed.*
- *The auditor is consulted during the on-site supervisory audit, and the Supervision delivers annual presentations on the findings of audits, providing an aggregate evaluation of the activities of the auditors, along with how adequate the separate supplementary auditor's report was.*

2. The supervisor has the authority to monitor the quality of work done by external auditors for supervisory purposes. The supervisor has the authority to directly appoint external auditors for conducting supervisory tasks or oppose the appointment of an external auditor that is deemed to have inappropriate expertise and/or independence.

- *This is OK.*
- *Action has to be taken involving the Auditors' Chamber to make sure that one is no longer retained.*
- *The Banking Act enables replacement of the auditor.*

3. The supervisor can also make use of external auditors to examine specific aspects of banks' operations, provided there is a well developed, professionally independent auditing and accounting profession with skills to undertake the work required. The respective roles and responsibilities for the supervisor and the auditors in these circumstances are clearly defined by the supervisor.

OK.

4. The supervisor has the legal right of full access to all bank records for the furtherance of supervisory work. The supervisor also has similar access to the board, senior management and staff, when required.

OK.

5. The supervisor has a programme for the periodic examination of supervisory returns by examiners or through the work of external auditors. There is a requirement that certain key supervisory returns such as that for capital adequacy be examined at least annually by the auditors and a report submitted to the supervisor.

- *In relation to the on-site supervisory audit and occasionally the supervisory auditor reviews key reports, the auditors submit their relevant reports to the Supervision each year.*

- *However, the regulator Ministry of Finance has brought up the wrong concept of terminating the specific separate reporting obligation of auditors.*

Additional criteria

1. The supervisor meets with management and the board of directors each year to discuss the results of the supervisory examination or the external audit. Such visits should allow for the supervisor to meet separately with the independent board members.

- *Members of the management team and bodies are met.*
- *External members of the bodies can also be met as required, the Supervision utilises this possibility on an ad hoc basis.*
- *Demand for this may be encountered in the course of risk assessment, but this is not a regular practice.*

2. The supervisor meets periodically with external audit firms to discuss issues of common interest relating to bank operations. (Reference document: “The relationship between bank supervisors and external auditors” – July 1989.)

In relation to the on-site supervisory audits the auditor concerned, sometimes all of the auditors are invited for discussions.

In the system of defence lines the responsibility and the strengthening of his accountability and relationship with the Supervision needs improvement.

Principle 20: An essential element of banking supervision is the ability of the supervisors to supervise the banking group on a consolidated basis.

Essential criteria

1. The supervisor is aware of the overall structure of banking organisations (i.e., the bank and its subsidiaries) or groups and has an understanding of the activities of all material parts of these groups, including those that are supervised directly by other agencies.

- *The Supervision has reviewed the structure of the groups according to the new principles.*
- *In the course of the reviews the structure and operation of groups are usually reviewed.*
- *The registry function of the KTA group is not working.*
- *As a consequence of its organisation structure and distribution of tasks as specified by the Supervision the individual institution and not the group is the basic unit of supervision. Consolidated supervision is therefore carried out as a supplementary activity, through separate procedures and committees.*

2. The supervisor has a supervisory framework that evaluates the risks that non-banking activities conducted by a bank or banking group may pose to the bank or banking group.

In relation to the quarterly risk assessment and the on-site supervisory audit the bank and the group is evaluated. The sup has methodology for auditing but it has no methodology for evaluation.

3. The supervisor has the legal authority to review the overall activities of a bank, whether the activities are conducted directly (including those conducted at overseas offices), or indirectly, through subsidiaries and affiliates of the bank.

- *The Supervision carries out audits in concert with partner authorities.*
- *The Supervision cooperates with other partner supervisory authorities concerning outsourcing.*

4. There are no impediments to the direct or indirect supervision of all affiliates and subsidiaries of a banking organisation.

- *Lack of language proficiency of employees is an impeding factor.*
- *The Supervision supports language training.*

5. Laws or regulations establish, or the supervisor has the authority to impose, prudential standards on a consolidated basis for the banking organisation. The supervisor uses its authority to establish prudential standards on a consolidated basis to cover such areas as capital adequacy, large exposures and lending limits.

- *Consolidated data are supplied by banks on a semi-annual basis.*
- *Group level risk management should be exercised more consistently.*

6. The supervisor collects consolidated financial information for each banking organisation.

This is to be submitted by those having groups.

7. The supervisor has arrangements with functional regulators of individual business vehicles within the banking organisation group, if material, to receive information on the financial condition and adequacy of risk management and controls of such business vehicles.

This is applicable in Hungary exclusively as a cross-border issue.

(Comment: in-house coordination between sectors and departments is ensured by Financial Holding Committees set up to strengthen the supervision of groups.)

8. The supervisor has the authority to limit or circumscribe the range of activities the consolidated banking group may conduct and the overseas locations in which activities can be conducted; the supervisor uses this authority to determine that the activities are properly supervised and that the safety and soundness of the banking organisation is not compromised.

Yes.

Additional criteria

1. For those countries that allow corporate ownership of banking companies:

- the supervisor has the authority to review the activities of parent companies and of companies affiliated with the parent companies, and utilises the authority in practice to determine the safety and soundness of the bank;
- the supervisor has the authority to take remedial actions, including ring-fencing, regarding parent companies and non-bank affiliates concerning matters that could impact the safety and soundness of the bank; and
- the supervisor has the authority to establish and enforce fit and proper standards for owners and senior management of parent companies.

(Reference documents: “Consolidated supervision of banks’ international activities” – March 1979; “The supervision of cross-border banking” – October 1996.)

- *The practice is not adequate. Only banking groups are supervised. Where the parent company is not a bank, we have no such power. (E.g. in the case of Budapest Bank HFSA exchanges information with the partner supervisory authority supervising GE, the direct owner. In the case of ÁÉB the owner is a private individual through enterprises)*
- *Supervision takes the form reviewing the exercising of ownership rights.*
- *Transactions can be restricted.*

Principle 21: Banking supervisors must be satisfied that each bank maintains adequate records drawn up in accordance with consistent accounting policies and practices that enable the supervisor to obtain a true and fair view of the financial condition of the bank and the profitability of its business, and that the bank publishes on a regular basis financial statements that fairly reflect its condition.

Essential criteria

1. The supervisor has the authority to hold management responsible for ensuring that financial record keeping systems and the data they produce are reliable, and that supervisor-required reports are submitted on a timely and accurate basis.

The sup has exercised its powers on several occasions, as was required.

2. The supervisor has the authority to hold management responsible for ensuring that the management report and financial statements issued annually to the public receive proper external verification and bear an external auditor's opinion.

Supervisory practice is expanded by the third pillar of Basel II.

3. The supervisor ensures that information from bank records is verified periodically through on-site examinations and/or external audits.

- *In relation to the on-site supervisory audit and on an ad hoc basis, the Supervision reviews key reports in the course of off-site surveillance as well.*
- *The auditors submit their relevant reports to the Supervision once a year.*

4. The supervisor ensures that there are open communication lines with the external auditors.

In relation to the on-site supervisory audits the auditor concerned and in some cases all of the auditors are invited for discussions.

5. The supervisor provides report instructions that clearly establish the accounting standards to be used in preparing supervisory reports. Such standards are based on accounting principles and rules that command wide international acceptance and are aimed specifically at banking institutions.

- *The MoF drafts law on accounting, the Supervision has a right to comment and make proposals.*
- *The Supervision has to ensure that the reports are compiled in accordance with the effective accounting regulations.*
- *The Hungarian accounting standard meets the international standards above 90 %, yet the differences may result in material differences between the Hungarian and the international statements.*
- *A number of institutions have called for continued approximation of the Hungarian standards, the delaying of which is caused by taxation related factors.*

6. The supervisor requires banks to utilise valuation rules that are consistent, realistic and prudent, taking account of current values where relevant, and that profits are net of appropriate provisions.

OK

7. Laws or regulations set, or the supervisor has the authority, in appropriate circumstances, to establish, the scope and standards to be achieved in external audits of individual banks, and to make public issuance of individual bank financial statements subject to its prior approval.

The MoF drafts law on accounting, the Supervision has a right to comment and make proposals.

8. The supervisor has the ability to treat as confidential certain types of sensitive information.

Yes.

9. The supervisor requires banks to produce annual audited financial statements based on accounting principles and rules that command wide international acceptance and have been audited in accordance with internationally accepted auditing practices and standards.

- *In relation to the on-site supervisory audit and on an ad hoc basis, the supervisory auditor reviews key reports in the course of off-site surveillance as well. The auditors submit their relevant reports to the Supervision once a year.*
- *The European requirement of standardised reporting service is expected to settle this issue, so it will not be bypassed.*

10. The supervisor has the right to revoke the appointment of a bank's auditors.

The Banking Act enables replacing the auditor. This has taken place in the practice of the Supervision as required.

11. Where supervisors rely primarily on the work of external auditors (rather than on their own examination staff), banks are required to appoint auditors who are recognised by the supervisor as having the necessary professional skills and independence to perform the work.

This is not part of the Supervision's current practice.

Additional criteria

1. The supervisor promotes periodic public disclosures of information that are timely, accurate, and sufficiently comprehensive to provide a basis for effective market discipline.

- *Banks have to publish the annual audited report.*
- *The Supervision may not publish institutional level data without consent of the supervised institution.*
- *Comprehensive reports are produced on the supervised sectors on a regular basis, which are published by the Supervision.*
- *The supervisory practice is supplemented by the third pillar of Basel II, no other measure has taken place in addition to those called for by the Accounting Act.*
- *Disclosure of the resolutions is special Hungarian practice.*

2. The supervisor has guidelines covering the scope and conduct of audit programmes that ensure that audits cover such areas as the loan portfolio, loan loss reserves, nonperforming assets, asset valuations, trading and other securities activities, derivatives, asset securitisations, and the adequacy of internal controls over financial reporting.

3. Auditors have the legal duty to report to the supervisor matters of material significance, for example, failure to maintain the licensing criteria, or breaches of banking or other laws. The law protects auditors from breach of confidentiality when information is communicated in good faith.

4. Auditors also have the legal duty to report matters to the supervisor, in situations where they become aware of matters which, in the context of the available information, they believe is likely to be of material significance to the functions of the supervisor.

Yes.

Principle 22: Banking supervisors must have at their disposal adequate supervisory measures to bring about timely corrective action when banks fail to meet prudential requirements (such as minimum capital adequacy ratios), when there are regulatory violations, or where depositors are threatened in any other way. In extreme circumstances, this should include the ability to revoke the banking license or recommend its revocation.

Essential criteria

1. The supervisor has the authority, backed by legal sanctions, to take an appropriate range of remedial actions against, and impose penalties upon, banks, depending on the severity of a situation. These remedial actions are used to address such problems as failure to meet prudential requirements and violations of regulations. They range from informal oral or written communication with bank management to actions that involve the revocation of the banking license.

- *The right to take actions is clearly defined and regulated, it is to manage problems justified on technical/professional grounds.*
- *The range of possible actions is broad enough (see. CP 22.1.2.)*
- *Fit and proper and corporate governance are missing from among the reasons for taking action.*
- *The possibility of applying measures and their practical application is, however, rather rigid (e.g. something that is not a concrete violation cannot be included in a resolution even if it violates prudential principles, one of the reasons for this is that the report does not contain a finding proposed as a point of a resolution elaborated sufficiently from the aspect of enforcement, and what is negligible from a prudential aspect but is a violation of the law, is contained in the resolution.). The inflexibility of this practice has been eased by the Supervisory Council in the wake of its decision made recently.*
- *Another consequence of the previous problem is that the supervisory actions appearing in the measures convey a fundamentally compliance type supervisory attitude to the public.*
- *The goals of supervision can be attained more effectively in the majority of cases through owners, either through personal meetings, 'financial interest' or reputation. These means should be more often used by the Supervision.*

2. The range of possible actions available is broad, including, in addition to the others mentioned, restricting the current activities of the bank, withholding approval of new activities or acquisitions, restricting or suspending payments to shareholders or share repurchases, restricting asset transfers, barring individuals from banking, replacing or restricting the powers of managers, directors, or controlling owners, arranging a takeover by or merger with a healthier institution, and imposing conservatorship.

- *The form of the applicable measures could be increased by introducing the Ket., if there were relevant authorisation in the status act.*
- *In the case of savings cooperatives the members of the board of directors do not qualify as persons in managerial positions, thus in commissioning a supervisory commissioner, the BOD is operating in parallel.*

3. The supervisor ensures that remedial actions are taken in a timely manner.

- *Development and effective operation of an early warning system is a pre-requisite*
- *Another pre-requisite is that the Supervision should have business continuity and disaster recovery plans and operate them effectively if necessary.*

4. The supervisor applies penalties and sanctions not only to the bank, but, when and if necessary, also to management and/or the board of directors.

- *The Supervision applies fines as necessary.*
- *The lack of the category of good business renown means at the same time a lack of the preventive force of the possibility of losing it.*

Additional criteria

1. Laws and/or regulations mitigate against the supervisor unduly delaying appropriate corrective actions.

- *The Banking Act prescribes that the Supervision has to act in time.*
- *Internal procedures have been set up to ensure timely identification and management of the problems at the necessary levels of management.*

2. The supervisor addresses all significant remedial actions in a written document to the board of directors and requires that progress reports are submitted in writing as well.

Principle 23: Banking supervisors must practise global consolidated supervision over their internationally active banking organisations, adequately monitoring and applying appropriate prudential norms to all aspects of the business conducted by these banking organisations worldwide, primarily at their foreign branches, joint ventures and subsidiaries.

Essential criteria

1. The supervisor has the authority to supervise the overseas activities of locally incorporated banks.

A new aspect aligned to the Basic Principle: cross-border activities of domestic banks (e.g. MKB, CIB).

2. The supervisor satisfies itself that management is maintaining proper oversight of the bank's foreign branches, joint ventures, and subsidiaries. It also satisfies itself that the local management of any overseas offices has the necessary expertise to manage those operations in a safe and sound manner.

- *Deficiencies of the assessment of the exercising of ownership rights and of corporate governance (management structure, operation of committees, proportion of independent external members etc.).*
- *This is not exercised in licensing.*
- *Partly applied in methodologies.*

3. The supervisor determines that bank management's oversight includes: a) information reporting on its overseas operations that is adequate in scope and frequency and is periodically verified; b) assessing in an appropriate manner compliance with internal controls; and c) ensuring effective local oversight of foreign operations.

See previous CP

4. The home country supervisor has the authority to require closing of overseas offices, or imposing limitations on their activities, if it determines that the supervision of a local operation by the bank and/or by the host country supervisor is not adequate relative to the risks the office presents.

- *Requirement of appropriacy of Supervision of the host country is not included among licensing criteria.*
- *Supervisory deficiency, as a legal basis, does not exist.*

Additional criteria

1. The supervisor has a policy for assessing whether it needs to conduct on-site examinations or require additional reporting, and it has the legal authority and resources to take those steps as and when appropriate.

The audit policy does not extend to audit aspects of foreign subsidiary banks of Hungarian banks.

2. The supervisor ensures that management's local oversight of foreign operations is particularly close when the foreign activities have a higher risk profile and/or when they differ fundamentally from those conducted in the home country, or are conducted at locations that are especially remote from the principal locations at which the bank conducts comparable activities.

In the course of the latest audit of the institution concerned this was ascertained by the Supervision.

3. The supervisor arranges to visit the offshore locations periodically, the frequency determined by the size and risk profile of the overseas operation. The supervisor meets the local supervisors during these visits.

See comments on 23.2.1..

Consultation is underway between supervisions, on-site audits have not been carried out at the institution.

4. The home country supervisor assesses the quality of supervision conducted in the countries in which its banks have material operations. (Reference documents: “Principles for the supervision of banks’ foreign establishments” – May 1983; “Minimum standards for the supervision of international banking groups and their cross-border establishments” – July 1992; “The supervision of cross-border banking” – October 1996.)

- No formal or informal rating produced

- Reviewing equivalence of supervisory systems of third countries is required by law.

Principle 24: A key component of consolidated supervision is establishing contact and information exchange with the various other supervisors involved, primarily host country supervisory authorities.

Essential criteria

1. For significant overseas operations of its banks, the home country supervisor establishes informal or formal arrangements (such as memoranda of understanding) with host country supervisors for appropriate information-sharing on the financial condition and performance of such operations in the host country. Information sharing arrangements with host country supervisors include being advised of adverse assessments of such qualitative aspects of a bank's operations as the quality of risk management and controls at the offices in the host country.

- *Major step forward during recent period, particularly in relation to Basel II.*
- *Different nature of EU and non-EU relationships.*

2. The supervisor can prohibit banks or their affiliates from establishing operations in countries with secrecy laws or other regulations prohibiting flows of information deemed necessary for adequate supervision.

3. The home supervisor provides information to host country supervisors concerning the specific offices in the host country, concerning the overall framework of supervision in which the banking group operates, and, to the extent appropriate, concerning significant problems arising in the head office or in the group as a whole.

- *Progress in relation to BII.*
- *Aspects of exercising of rights of owners and risk management to be strengthened in general and in relation to cross-border transactions.*
- *Development of a home-host strategy is in progress.*

Additional criteria

1. A supervisor who takes consequential action on the basis of information received from another supervisor, consults with that supervisor, to the extent possible, beforehand.

No data.

2. Even for less than significant overseas operations of its banks, the home country supervisor exchanges appropriate information with host country supervisors. (Reference documents: same as for Principle 23.)

The existing relationship is occasional, there is an intent to make it regular.

Principle 25: Banking supervisors must require the local operations of foreign banks to be conducted to the same high standards as are required of domestic institutions and must have powers to share information needed by the home country supervisors of those banks for the purpose of carrying out consolidated supervision.

Essential criteria

1. Local branches and subsidiaries of foreign banks are subject to similar prudential, inspection, and regulatory reporting requirements as domestic banks.

- *The same deficiencies exist, there are no differences,*
- *An EU and not an EU-branch office problem.*

2. For purposes of the licensing process as well as ongoing supervision, the host country supervisor assesses whether the home country supervisor practices consolidated global supervision.

- *Deficient assessment of parent supervisions.*
- *Not properly considered in practice, we cannot assess the quality of consolidated supervision.*
- *The equivalence assessment of third countries is not properly elaborated.*

3. The host supervisor, before issuing a licence, determines that approval (or no objection) from the home supervisor has been received.

- *We demand certification of only that the parent bank is operating prudently and in practice it meets requirements*
- *We do not check however, whether approval covers the issue of 'fit and proper'.*

4. The host country supervisor can share with home country supervisors information about the local operations of foreign banks provided its confidentiality is protected.

5. Home country supervisors are given on-site access to local offices and subsidiaries for safety and soundness purposes.

6. The host country supervisor advises home country supervisors on a timely basis of any material remedial action it takes regarding the operations of a bank from that country.

Additional criteria

1. The host country supervisor obtains from home country supervisors sufficient information on the banking group to allow it to put into proper perspective the activities conducted within its borders. (Reference documents: same as for Principle 23.)

Information is not requested on a regular basis, only as required, but practically it is asked for in the majority of cases.