



PÉNZÜGYI SZERVEZETEK  
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HUNGARIAN FINANCIAL  
SUPERVISORY AUTHORITY

Technical documents relating to the new capital requirement directives (CRD) for credit  
institutions and investment firms

(2<sup>nd</sup> revised version)

**July 2005**

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**TABLE OF CONTENTS**

1	Summary .....	3
2.	Proposal concerning the structure of transposing the new European capital requirement directives (CRD) in the Hungarian national legislation .....	4
3.	The basic principles of the adoption of the new European directives concerning the calculation of capital requirements for credit institutions and investment firms .....	7
4.1	Exemption from certain requirements comprised in the Directive .....	12
4.2	Risk weighting in the standardised method.....	13
4.3.	Application of preferential treatment .....	14
5.	Potential legal problems and special features of the Hungarian market, that credit institutions and investment firms may face while implementing prospective capital requirement directives .....	16
5.1	Questions relating to credit risk mitigation in the new capital requirements directive .....	17
5.2.	Interpretation and treatment of interest accrual in the new directive .....	21
5.3.	Issues relating to the Hungarian provisions on data protection .....	22
5.4.	Minimum requirements concerning the rating system, in the internal ratings based methods .....	23
5.5.	Supervisory discretionary decisions.....	24
5.6	Market circumstances.....	25

ANNEX:

ANNEX 2: SUPERVISORY PROPOSAL CONCERNING DISCRETIONARY ISSUES

## 1 Summary

At the ECOFIN Council meeting on 7 December 2004 the European Commission approved draft Directives containing capital requirement regulations for credit institutions and investment firms. The European Commission submitted, in June 2004, its formal amendment proposals with the aim of creating a new European regulatory framework, initiating amendments to Directives 2000/12/EC and 93/6/EEC underlying the existing regulatory environment. The amendments were aimed at transposing the recommendations of the Basel Committee on Banking Supervision (known as Basel II), into the European legislation.

In the wake of the decision taken by the ECOFIN Council the proposals progressed to the next step in the European legislation process, to the European Parliament. Owing to the large number of motions for amendment, the proposals are expected to be approved by the Parliament later than planned, possibly in September 2005 if approved upon first reading. Thereafter the Council can finalise the draft Directives in November 2005.

The relevant institutions and agencies in Hungary have already started preparations for the new regulation, the process of which has, this year again, been assessed by the HFSA (Hungarian Financial Supervisory Authority) in the form of a questionnaire. At the bilateral and multilateral consultations institutions have often asked to be shown, as soon as possible, the draft of the Hungarian regulations to be formulated on the basis of the Directive, along with the principles of the application and enforcement of the law on the part of the HFSA. The situation is complicated by the fact that although the ECOFIN meeting approved the draft Directive, the actual text of the Directive may still be modified in the course of the EU Parliament procedures. Albeit the Directives have not yet been passed by the European Parliament, a number of arguments call for starting the process of transposing the text of the Directives into the Hungarian national legislation:

- The Directive radically transforms the mode of calculating the solvency ratio, which requires a broad range of amendments to a large number of legal regulations concerning financial matters.
- Adopting the new directive will be a complex task, owing to the wide range of areas concerned, and the length of the text and the depth of detail of the regulation will impose a substantial work load on experts.
- The sector has major expectations with respect to the publication of the new Hungarian regulation, since they have started working on preparations and have implemented substantial investments. The HFSA is receiving an increasing number of requests for position statements concerning concrete specific regulatory issues.

A precise knowledge and understanding of the actual text of the Directive as well as the elaboration of the drafts of the relevant national pieces of legislation - which is required as a basis for formulating the Hungarian standpoints to be represented in the various international working groups with respect to the implementation of the Directives - is also necessary for the HFSA for its own preparations and for setting its own tasks.

In view, however, of the size of the European legislation that needs to be transposed, and of the fact the final version will only be published at a later date, in the first step of the Hungarian legislation process, working out documents focusing on conceptual issues seems to

be the most important task for the time being. These efforts have so far resulted in the following papers:

- Proposal for the structure of transposing the new European capital requirement directive (CRD) into Hungarian legislation
- Basic principles of adopting the new European capital requirements directive for credit institutions and investment firms
- Discretions in the new European capital requirement directive
- Potential legal problems and special market characteristics that may be encountered in the course of the implementation of the future capital requirement directives for credit institutions and investment firms

In February 2005 the HFSA released these documents to a broad range of stakeholders for consultation, and comments were received from the National Bank of Hungary (NBH), the Hungarian Banking Association, OTP, MTB (Hungarian savings cooperatives bank), OTIVA (national savings cooperatives' institution protection fund), TЭСZ (national interest representing organisation of savings cooperatives) and BSZSZ (association of investment service providers). After consideration of the comments received the papers were redrafted, and the HFSA's re-considered standpoint will be described below. It should be stressed, however, that none of the documents should be regarded to be the final standpoint of the HFSA, they reflect concepts based on current knowledge, which may still be modified as the Directive is processed in detail, as market participants and other competent authorities are consulted and as related international supervisory standards are published.

## **2. Proposal concerning the structure of transposing the new European capital requirement directives (CRD) in the Hungarian national legislation**

This paper contains a summary of the main areas to be affected by the changes, along with proposals concerning the levels at which they should be regulated. The main principles of the proposals are as follows:

- the smallest number of actually necessary rules should be introduced at the highest level of legislation, to enable quick and flexible introduction of any necessary amendments in the future,
- amendments should be introduced to the smallest possible number of pieces of legislation to provide for clarity (unambiguous regulation) and traceability,
- duplications should be avoided, one rule should appear only in one piece of legislation.

One question to be decided is whether all of the supervisory discretionary powers should be enshrined in law or would it suffice to identify them in decrees issued by the Government or the Ministry of Finance. If they were to be enshrined in law, these elements should then be removed from the list of issues proposed to be regulated by decrees to be issued by the Government or the Ministry of Finance.

The proposed legislative structure of the new capital requirement directives is presented in the following table:

Title of piece of legislation	2000/12/EC	93/6/EEC
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Act CXII of 1996 on credit institutions and financial enterprises	supplementation and modification of definitions (A4)	
	changes affecting the calculation of the regulatory capital (on the basis of comparison of expected loss and provisioning /value loss/, based on positions originating from securitisation transactions, A57, A63, A64)	
	supplementation of the rules concerning the internal structure of regulatory capital (A66)	
	scope of application (A68-A73)	
	minimum capital requirements (A75)	
	methods of calculating capital requirement for credit risks (A76)	
	detailed description of the methods of calculating capital requirements for credit risks (A78-101)	
	prescription of capital requirement for operational risks (A102-105)	
	change in the basis of calculation as applied in the rules on assuming large risks (A108, A111)	
	change in the definition of 'large risk' (A112-117)	
	calculation of economic capital increment (A123)	
	supervisory procedure (A129)	
	cooperation between supervisory authorities (A130-A132)	
	supervisory sanctions (A136)	
	belonging of asset management enterprises to consolidated supervision (A134)	
	types of information to be published by credit institutions (A145-149)	
	transitional minimum capital requirement rules (A152-155)	
	technical criteria for risk management and organisation (Annex V)	
	supervisory review and evaluation process (Annex IX)	
Act CXX of 2001 on the capital market		rules to be applied to investment enterprises (A2)
		changes in definitions (A3)
		items belonging to the trading book (A11)
		treatment of expected losses (A17)
		possibility of applying simplified capital requirement for a group of investment enterprises (A20)
		possibilities for exemption from coming under consolidated supervision (A22, 24, 25)
		supervisory procedures for investment enterprises based on 200/12/EC Directive (A37)
		publication requirements (A39)
Act CXXIV of 1999 on the Hungarian Financial Supervisory Authority	publication of supervisory information (A144)	
Government Decree No. 244/2000. (XII. 24.) on the rules on establishing the capital requirement to cover positions and risks recorded in the trading book and large risks, and on the detailed rules		treatment of quality bonds (A19)

on keeping the trading book		
		treatment of recognised third country investment enterprises, recognised clearing houses and exchanges, as institutions (A40)
		treatment of credit derivatives in the course of the calculation of the capital requirement (Annex I, 8, 42-46)
		modification of the treatment of quality bonds (Annex I, 14-16)
		capital requirement of investment units (Annex I, 47-56)
		modification of capital requirement for partner risk (Annex II, 3-11)
		taking account of investment units in the calculation of foreign exchange open positions (Annex III)
		termination of possibility of applying alternative method in the calculation of foreign exchange open positions (Annex III)
		foreign exchange rate risks of investment units in the internal model (Annex V, 13)
		trading intent, systems and controls, valuation procedures, hedging transactions (Annex VII)
Decree No. 13/2001. (III. 9.) PM (Ministry of Finance) on the calculation of the capital adequacy ratio	standard method (Annex VI)	
	internal rating method (Annex VII)	
	credit risk mitigation (Annex VIII)	
	capital requirement of securitisation (Annex IX)	
	capital requirement of operational risks (Annex X)	
Decree No. 23/2003. (X. 3.) PM on the calculation of the consolidated regulatory capital and of the solvency ratio calculated on a consolidated basis	changes affecting the calculation of the regulatory capital (based on comparison of expected loss and provisioning, based on positions derived from securitisation transactions) (A57, A63, A64)	
	supplementation of rules on the internal structure of the regulatory capital (A66)	
Decree No. 55/2002. (XII. 30.) PM on the range of data to be provided by credit institutions and financial enterprises for the Hungarian Financial Supervisory Authority and the mode of data supply	development of a new reporting system, linked to the changes in legislation	
Decree No. 5/2004. (II. 12.) PM on the obligations of investment service providers and branch units in Hungary of investment service providers and having their registered seats abroad to provide information on their business and service providing activities, of investment enterprises and credit institutions to provide information on the keeping of their trading books, and of the commodity exchange service provider and the clearing house on their service providing activities, for the Hungarian Financial Supervisory Authority		development of a new reporting system, linked to the changes in legislation

In relation to transposing the new European capital requirements directive in the Hungarian legislation, pieces of legislation need to be amended in the following areas affecting the new regulation in a broader sense.

1. Decree No. 14/2001. (III. 9.) PM on the criteria of rating and evaluating receivables, investments, off-balance sheet items and collateral security items
2. Act LXIII of 1992 on the protection of personal data and the publicity of data of public interest
3. Act XLIX on bankruptcy proceedings, liquidation proceedings and the final settlement of accounts
4. Act IV of 1959 on the Civil Code
5. Act XXXVIII of 1992 on public finances

The above amendments are required for ensuring availability of information required for the calculation of capital requirements by a method based on internal rating (IRB) and for making it possible to meet the minimum requirements (e.g. use test) for application; and they make it possible to ensure legal enforceability of the instruments that can be recognised for credit risk mitigation, including the settlement of any outstanding issues relating to the position of state-backed guarantee institutions and the maintenance of their statuses in the new regulation, for the effective performance of their activities in the future. Furthermore, regulatory conditions for securitisation transactions also need to be created.

### **3. The basic principles of the adoption of the new European capital requirements directive for credit institutions and investment firms**

In order to ensure effective preparations by authorities and institutions it is necessary to lay down and publish the most important principles of the regulations that will have to be formulated in the future. 'Laying down' does not mean here that no departure is permitted from a given point in view of new information, rather, it means that on the basis of the currently available wealth of information the process of preparation of the amendments to domestic legislation is proposed to be conducted in view of the following basic principles.

1. In elaborating the proposal concerning Hungarian legislation the relevant EU Directive has to be taken into account primarily. In the course of regulation the fundamental principles and procedural techniques elaborated in the EU committees, sub-committees and working groups (CEBS, CESR, Groupe de Contact etc.) will also be taken into account. The recommendation of the Basel Committee should be taken into account where it describes detailed procedures that are not included in the EU Directive or that are included in the EU Directive in insufficient detail. In this case too, however, the reasons for the difference need to be reviewed, along with the possible impacts of the application in Hungary of the Basel regulations and the necessity of their adoption at the level of legislation.

2. The preparation and entering into force of the domestic pieces of legislation should be scheduled in a way as will ensure that they enter into force 6 months before the date from which the new capital requirement calculation methods have to be applied (i.e. by 30 June 2006, according to the current state of affairs), enabling the submission to the HFSA and review and decision making by the HFSA, of the applications for approval of the advanced methods, along with cooperation between the HFSA and the supervisory authorities of other EU Member States in the process of granting approvals.

3. The process of amending legislation has to be conducted through broad consultation and coordination, which, however, does not exclude restricting consultation and coordination to the authorities (Ministry of Finance, HFSA, NBH, Ministry of Justice) in some cases in the course of the discussion of certain law amendment proposals. The regulatory authorities are informing market participants about the progress of the legislation process, on an ongoing basis. Decisions taken on issues in dispute concerning introduction are also regularly communicated to institutions.

4. One important element of the coordination and consultation process is making decisions concerning national and supervisory discretionary options allowed by the Directive, along with communication of such decisions to institutions making their own preparations.

5. Discretionary decisions are made in view of the following principles:

- the Hungarian regulation provides for the possibility of preferential procedure except where important circumstances of departure in regulation or market features do not make it possible;
- the Hungarian regulation recognises the decisions of other EU Member States concerning the preferential treatment with respect to a given issue, to enable their application by Hungarian institutions as well, unless the regulators have definite interests concerning the rejection of the preferential terms;
- if the Directive makes it possible to apply the preferential procedure only for an interim period, the Hungarian regulation applies the preferential procedure, unless it expressly violates Hungarian interests;
- the discretionary powers of the HFSA should increase, that is where the Directive delegates a decision to the supervisory level, the Hungarian regulation should grant such power to the HFSA.

6. In the course of the elaboration of the new capital requirement rules all of the regulations, which, in their current form, contain tighter regulations than the EU Directive, should be reviewed.

7. In adopting the new capital requirement rules the permissive type rules should be incorporated in the Hungarian regulation. In this way practices that do not exist yet, can develop in line with conditions already laid out in the regulations.

8. In the legislation process efforts should be made to achieve clear wording and a transparent regulation structure. In order to increase transparency the HFSA will, in line with the provisions laid out in the Directive, the most important pieces of information relating to supervisory practices, including particularly the validation procedures and the methods relating to the supervisory review process.

9. The implementation of the new European capital requirements directives will affect the Hungarian regulations of the money and capital markets at the level of Acts of law, government decrees and Ministry of Finance decrees alike. Amendments will have to be introduced to the following pieces of legislation.

- Act CXII of 1996 on credit institutions and financial enterprises
- Act CXX of 2001 on the capital market
- Act CXXIV of 1999 on the Hungarian Financial Supervisory Authority (and the single supervisory procedural act which is in preparation)
- Government Decree No. 244/2000. (XII. 24.) on the rules on establishing the capital requirement to cover positions and risks recorded in the trading book and large risks, and on the detailed rules on keeping the trading book
- Decree No. 13/2001. (III. 9.) PM (Ministry of Finance) on the calculation of the capital adequacy ratio

- Decree No. 14/2001. (III. 9.) PM on the criteria of rating and evaluating receivables, investments, off-balance sheet items and collateral security items
- Decree No. 23/2003. (X. 3.) PM on the calculation of the consolidated regulatory capital and of the solvency ratio calculated on a consolidated basis
- Government Decree No. 250/2000. (XII. 24.) on the special features of the obligations of credit institutions and financial enterprises to prepare their annual reports and keep their books
- Government Decree No. 251/2000. (XII. 24.) on the special features of the obligations of investment enterprises to prepare their annual reports and keep their books
- Decree No. 55/2002. (XII. 30.) PM on the range of data to be provided by credit institutions and financial enterprises for the Hungarian Financial Supervisory Authority and the mode of data supply
- Decree No. 5/2004. (II. 12.) PM on the obligations of investment service providers and branch units in Hungary of investment service providers and having their registered seats abroad to provide information on their business and service providing activities, of investment enterprises and credit institutions to provide information on the keeping of their trading books, and of the commodity exchange service provider and the clearing house on their service providing activities, for the Hungarian Financial Supervisory Authority

10. The capital requirement expectations (pillars 1 and 2) have to be in proportion to the risks associated with the given institution. Institutions have to be stimulated to apply more advanced methods but before giving them the necessary licences, it must be ascertained that the advanced techniques are parts of an advanced and integrated risk management process (use test).

11. In developing the criteria and conditions applying to advanced methods the regulatory authorities will take account of the purpose of the Directive that rules should not hinder the application of 'best practice' solutions. For this reason the principle based approach of the relevant sections of the Directive should be laid out in concrete forms only to the extent where it still does not hinder the attainment of this goal. As a general rule, the supervisory expectations concerning the application of advanced methods appear in the published validation methodology (section 1.7.). In the case of the various explicit discretionary powers it will have to be reviewed whether they need regulation by law.

12. The regulators formulate the system of expectations in a way as will ensure that the burden of conformity (meeting requirements) is proportionate to the benefits that can be available at the level of institutions and the whole of the money and capital market system in terms of increased stability and more transparent operation.

13. In view of the high proportion of foreign ownership in the Hungarian market and of the expansion of Hungarian credit institutions abroad, it is highly essential from the aspect of financial stability that adequate prudential supervision of domestic institutions be carried out in the course of consolidated supervision performed by foreign supervisory authorities as well. To ensure this, there is a need for continuous exchange of information between the relevant supervisory authorities. In the course of such cooperation efforts should be made to reach agreement in interpreting the Directive and in the supervisory practices to be developed, for which the methodology materials that have been prepared in the European Union for supervisory practices and that have been approved jointly by the relevant supervisory authorities.

14. In the elaboration of the proposed amendments to Hungarian legislation problems that may result in difficulties in the domestic application of the new capital requirement regulation, have to be identified. In elaborating the proposed amendments

attention will also have to be paid to the special features of the domestic regulatory environment and the domestic market. For this reason instead of simply transposing the text of the Directive word by word, its implementation means application of the provisions of the Directive in the domestic legislative environment.

15. The regulatory authorities are making efforts to ensure that institutions applying advanced methods carry out their capital requirement calculations based on data adequately representing their own portfolios. To this end, the more favourable data requirements as specified in the Directive will be included in the Hungarian regulation. If an institution wants to apply an external or a group level database in calculating the capital requirement, then

- in the case of the credit risk it must be proven that the external or group data to be used adequately represent the institution's portfolio or can be adequately adjusted to represent their portfolios as expected.
- in the case of the operational risk it must be proven that the external or group level operational loss data adequately represent the risks inherent in the operation of the institution concerned, or can be adequately adjusted to represent their risks as expected.

16. The regulatory authorities are monitoring the processes of preparations of the various institutions, but they also get prepared, on an ongoing basis, for performing their tasks stemming from the new regulations.

17. In parallel with the elaboration of the new regulation proposals the following need to be carried out:

- reviewing regulations concerning the rating and valuation of receivables, investments and off-balance sheet items,
- laying out risk management regulations concerning various types of risks, in decrees,
- prescribing special data supply requirements linked specifically to the introduction of the new capital requirement calculation rules, before 2007 (e.g. calculation of LGD, PD data),
- reviewing regulations concerning the enforcement of collaterals,
- reviewing data protection regulations.

The elaboration of the data supply regulations related to the new capital requirement rules should be adjusted to the work processes underway in the EU (COREP), to minimise the costs to be incurred by institutions as a consequence of the introduction of the new data supply requirements.

#### **4. Discretion issues in the new European capital requirements directive**

The EU Directive updating the calculation of the regulatory capital requirement of credit institutions and investment firms (amendments to Directives 2000/12/EC and 93/6/EEC), contains a number of questions relating to application concerning which the Member States and their supervisory authorities have to make decisions. Such decision making points provide for the flexibility aimed to be accomplished in the application of the Directives, with the aid of which the Member States can transpose the EU directives in accordance with the special local features of their own markets. As a matter of course, the large number of discretion issues and the resulting potentially different practices may endanger the application of the new directive in the internal market. For this very reason, in order to attain a balance between adequate flexibility and harmonised application, the European regulators have conducted several rounds of consultations with the national

supervisory authorities and the participants of the financial sector. These consultations have enabled a reduction of the number of national discretions.

The national discretion issues listed herein have been taken out of the Commission's proposal<sup>1</sup> concerning the Directive containing the Council's modifications as well, and they are presented in a thematic breakdown together with the proposals concerning their application<sup>2</sup>. The English and Hungarian language explanation of the discretions is only a brief summary of the questions, and since they are presented taken out of their context, they cannot always be understood separately. The conditions relating to the issues have, in some cases, not been presented because of the level of detail and of length of description, thus the material can be read and interpreted properly only together with the whole text of the Directive<sup>3</sup>.

Preliminary supervisory decisions have been made to date on two occasions with respect to the application in Hungary of national discretions: in relation to the third quantitative impact survey (QIS3) carried out by the Basel Committee in 2002, in which Hungarian banks also participated, and upon the survey carried out by CEBS (Committee of European Banking Supervisors) in 2004 among European supervisory authorities. In both of these cases the decisions were made on the basis of knowledge and the text/content of the latest drafts of the Directive available at the time, thus the issues and decisions presented herein may differ from the earlier ones.

The purpose of the material containing national discretion issues and decisions is to sum up the standpoint of the Hungarian supervisory authority for the sector with respect to the application of various provisions of the Directive. With respect to one of the uncertainty factors relating to the application of the Directive these decisions provide an important point of reference for the participants of the financial sector and they also help them perform the test calculations aiming at establishing the expected capital requirements of the institutions. Since however, the texts of the Directives have not yet been finalised, and the proposals for amendments to the Hungarian regulations will also be elaborated in the future, it should be emphasised that this material must not be regarded to be the final standpoint of the HFSA; rather, this is a working paper that should underlie continued technical/professional discussions and consultations.

The Directive contains a wide range of national discretion issues in terms of their nature and importance. They include issues that have a fundamental impact on the application of the provisions of the Directive by the Member States (e.g. granting of exemptions from having to meet requirements on certain levels, granting of preferential treatment), which need principle based decisions - i.e. in-depth consideration - along with not so crucial issues, of a technical nature, like for instance those relating to calculations. The following is a description

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<sup>1</sup> 486(COMfinal Commission proposal supplemented with the compromise document submitted to the Council and adopted in December 2004 (14919/1/04 ECOFIN 388 EF 54 CODEC 1255).

<sup>2</sup> In the table attached, the discretions to be applied are marked X, i.e. the HFSA does not - according to its current standpoint - intend to avail itself to discretions that have not been marked X. The two columns show the original and the modified supervisory standpoints. Discretions on which comments were received in the course of the consultation process in relation to some of which the HFSA's standpoint was modified, have been highlighted. The list of discretions published in the paper put out for consultation has also been supplemented.

<sup>3</sup> Furthermore, the paper does not contain issues relating to securitisation: decision on their application in Hungary will be made only at a later stage, and issues that are also included in the currently effective text of the Directive and have not been amended, are not presented either.

of the positions we are proposing, with respect to the most important ones of the more than a hundred issues, along with brief explanations<sup>4</sup>.

The approximately twenty issues considered to be the most important ones may be grouped according to the target of the discretionary decision. Some issues make it possible to grant exemption from having to meet certain requirements of the Directive on certain levels, others relate to the choice of the method in the calculation of capital requirement, while a third group includes discretions making it possible to apply preferential risk weighting or a temporary loosening of the requirements.

We propose that the following principles be taken into account in making decisions with respect to the discretionary issues included in the Directive, in the course of the transposition of the directive in the domestic legislation:

- the Hungarian regulation should provide for the application of the preferential treatment in all cases except where this is not permitted by important circumstances of departure in regulation or market features do not make it possible;
- the Hungarian regulation recognises the decisions of other EU Member States concerning the preferential procedure with respect to a given issue, to enable their application by Hungarian institutions as well, unless the regulators have definite interests concerning the rejection of the preferential terms (mutual recognition);
- if the Directive makes it possible to apply the preferential treatment only for an interim period, the Hungarian regulation applies the preferential treatment, unless it expressly violates Hungarian interests;
- the discretionary powers of the HFSA should increase, that is where the Directive delegates a decision to the supervisory level, the Hungarian regulation should grant such power to the HFSA.

#### **4.1 Exemption from certain regulations comprised in the Directive**

The Directive makes it possible for the Member States to grant exemptions to their institutions from having to meet certain requirements, under strictly defined conditions. Thus subsidiaries under the same supervision with their parent institutions may be exempted from having to calculate capital requirement on an individual basis (Articles 1 and 69). This instrument of prudential supervision is, however, considered by the HFSA to be an indispensable element of supervision, so the HFSA does not support its application.

The Directive also makes it possible to grant exemption from calculating capital requirement on an individual basis for exposures within a group (that is weighting at 0%), also under strict conditions (Article 5, Article 80 (7)). With respect to this issue the current position of the HFSA - in view of the comments received - is that the discretion should appear in the Hungarian regulation in that the HFSA decides - based on its consideration of whether the relevant conditions are met - whether the given institution may apply the preferential zero

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<sup>4</sup> The numbering reflects the numbering as per the enclosed paper containing the supervisory standpoint concerning the discretions. The references relate to the version of the relevant official Commission proposal supplemented with the modifications proposed by the Council.

percentage risk weight for transactions within the group. The HFSA is conducting a study of the potential impacts of the application of this discretion.

The standard group level application of advanced methods (IRB, AMA), is linked to the exemption possibility (of importance from the aspect of supervision), which permits - in the case of agreement of the competent supervisory authorities - that institutions meet the minimum requirements for the application of these methods on a group level, in aggregate, (IRB - Articles 25, 28 (2), AMA - Article 108, 105 (4)), without the members of the group having to meet the relevant minimum requirements on an individual basis. We do not support the application of this discretion since in this way the HFSA - as host supervisory authority - would lose one of the most important bases of reference in the licensing process (i.e. that subsidiaries should meet minimum requirements on a solo basis).

The disclosure requirements introduced by the new regulation carry important pieces of information on the own funds, nature of activity and risk management of an institution. Exemption from having to meet these requirements on an individual level is not recommended by the HFSA either (Article 118, Article 72 (3)). We do not see it ensured that consolidated information published by a parent institution incorporated in a third country would also carry the information content required for customers to make their decisions or the information content required by the Hungarian national regulations.

In the case of exposures covered by residential real estates the Directive makes it possible to grant exemption from meeting certain recognition requirements of the real estate concerned (Article 84. Annex 6, Part 1, paragraph 46 / Article 92. Annex 8. Part 1, paragraph 16). The HFSA considers that this discretion may be adopted in the Hungarian regulation but the application of the discretion, i.e. making a judgement of whether the conditions are met in the circumstances of the Hungarian market, is to be considered by the HFSA.

The draft of the Directive and the currently effective European directives make it possible for assigning a preferential 50 % risk weight to exposures covered by commercial real estate, instead of a 100 % weighting factor (Article 86, Annex 6., Part 1, paragraph 48). In the paper published in February the HFSA did not support granting permit for the application of this preferential risk weight, because only 50 % of real estate involved in liquidation procedure may be used for repayment of a debt covered by mortgage, according to the effective provisions of the Bankruptcy Act. Should an amendment to the Bankruptcy Act enable the legal enforcement (settlement) condition that is required for recognising commercial real estates as collateral security items, the possibility of the 50 % weighting factor may be adopted by the Hungarian regulation, however, the application of the preferential treatment depends on the view taken by the HFSA of whether the criteria specified in the Directive are met.

## **4.2 The risk weighting in the standardised method**

### *Risk weighting of exposures to credit institutions and investment firms*

One of the most important discretion issues of the Directive - relating to the selection of the method - relates to the risk weighting of exposures to credit institutions and investment firms (hereinafter: institutions, as applied by the Directive) (Article 4, Article 80 (3) / Annex

6, Part 1, paragraph 24). According to the Directive, supervisory authorities / Member States may choose from two options for weighting exposures:

Option 1: A riskweight that is one grade higher than the risk weight originating from the external rating of the state;

Option 2: Applying the risk weight originating from the institution's own external rating.

The HFSA is conducting an impact assessment to support its decision concerning the option to be applied.

#### *Risk weighting options to regional and local governments*

The existing Hungarian regulation sets a 100 % risk weight - significantly higher than in the practices of other EU Member States - to exposures to Hungarian local governments. This regulation originates from the early 90s when the introduction of the new local governmental system entailed a lot of uncertainties. Experience to date show that though cases of default do occur among local governments as well, on the whole, however, a 100 % risk weight is considered to be rather excessive. The current version of the draft Directive makes it possible to reduce the risk weight on the exposure to Hungarian local governments to 50 %. In their case one of the risk weighting methods applicable to exposures to institutions may be applied. Irrespective of the method to be chosen the same (50%) risk weight is arrived at in both cases for Hungarian local governments since the maturity benefit cannot be applied in the case of either option (which could reduce the risk weight to 20 %). Application of Option 1 however, may seem to be more favourable in a longer run depending on the improvement of the sovereign rating of Hungary.

The HFSA has no concrete details on local governments' default cases therefore the HFSA recommends that market participants should conduct an impact assessment based on joint data of banks operational in the local governmental division.

### **4.3. Application of preferential treatment**

In line with the basic principles concerning the application of national discretions the HFSA is in favour of the possibility of the preferential treatment in all cases, except where the application of the preference is not permitted/justified by important circumstances of departure in regulation or market features. One example for the latter is that the HFSA does not recommend that the 90 day default time limit - accepted and applied in the Hungarian practices - be raised in the definition of default in the standard method for exposures against enterprises (Article 9, Article 154, paragraph 1A). This is expected to be applied by Italy, Spain, Portugal, owing to their market practices.

Preferences relating to the level of development of markets (e.g. mortgage market) are to be introduced in the Hungarian regulation as a possibility, enabling the application of the method in the future, if the markets progress and sufficient data are available.

Some of the discretions relating to easing certain requirements of the Directive are linked to the minimum requirements of the application of the internal ratings based approach. From among these, the loosening of the directive s concerning the necessary databases (IRB - two years' data series suffice (Article 451, Annex 7, Part 4, paragraph 56), data collected before entry into effect can be treated more flexibly (Article 451, 7. Part 4, paragraph 56) AMA - three years' data series suffice (Article 114, Annex 10, Part 3, paragraph 13)), is

considered to be justified because its application makes it significantly easier for institutions to adopt the advanced method. A belated finalisation of the Directive - and so belated publication of the amendments to the Hungarian legislation as well - would make it difficult to start with the internal rating method at the time of the entry into force of the directive, without applying an easier version of the requirements of the Directive.

Discretion also proposed by the HFSA to be applied, which would make it possible to reduce by the supervision of the three year application requirement (meeting of the provisions of the Directive by the rating system and utilisation of the output for purposes of risk management) would also make it easier to start applying the internal rating method during the interim period following the entry into effect of the Directive (Articles 33-34, Article 154, 1B-C). The Directive permits partial introduction of the internal rating method as well, on the basis of which the standard method may be applied to exposures to the state/central bank and to institutions, if the relevant conditions are met (Articles 27, Article 89 1.). This discretion should also be applied in our view, since Hungarian institutions have a limited number of partners in this exposure category, which would not require the development of a rating system.

Similarly to the standard method, the internal rating method also permits preferential treatment of corporate exposures. In view of the average size of a Hungarian enterprise, there is a definite need for the application of corporate size adjustment to exposures to enterprises categorised as corporate, with smaller amounts in annual revenues (Article 38, Annex 7 Part 1 paragraph 4). This procedure recognises that these exposures can be more highly diversified at a portfolio level and that they are less sensitive to macroeconomic cycles.

In the standard method the possibility of applying risk weighting to central bank reserves placed with credit institutions as exposures to the central bank (Article 18, Annex 6, part 1, paragraph 38A, modification by Council), is of particular importance especially from the aspect of savings cooperatives whereby equal conditions can be provided for all institutions with respect to the placement of reserves (this has been added to the draft on the basis of a Hungarian initiative). Its application, however, would require an adequate amendment to the Bankruptcy Act.

The HFSA also intends to apply the possibility of mutual recognition in the recognition of the ratings of external rating institutions for the purposes of calculating capital requirements (Article 6, Article 81 (3)), since this could substantially simplify the applicability of ratings given by international rating institutions.

In the case of investment enterprises the Directive contains preferential treatments that can be applied at the discretion of the various supervisory authorities with respect to the calculation of the operational risk. Investment enterprises having licences for the provision of restricted ranges of investment services may be exempted from having to calculate the capital requirement for their operational risks (Article 102, Directive 93/6/EEC, Article 20 (2)), which is justified by the lower risks entailed by the activities of such institutions and the excessive capital requirement calculated in accordance with the new methods (so their capital requirement would not change in comparison to the existing requirement). Accordingly, we are in favour of the application of the discretion in Hungary.

The Directive also permits preferential treatment of OTC derivatives. Under specific criteria (daily deposit adjustment, complete coverage by top quality collateral security items),

these exposures may be exempted from capital requirement calculation, so they can be taken into account in the calculation of the capital requirement at zero exposure rate (Article 49, Annex 7, part 3, paragraph 8). If the conditions are met, the exemption should be granted.

The detailed responses of the HFSA concerning the comments received in the course of consultation process with respect to the various discretions are laid out in Annex 1. The reconsidered supervisory proposals concerning the whole range of discretionary decisions are presented in Annex 2.

## **5. Potential legal problems and special features of the market, that credit institutions and investment firms may face while implementing prospective capital requirement regulations**

One general problem in the course of the implementation of the Directives is that little attention is paid to the special regulatory frameworks of the various individual Member States in the course of the drafting of Directives. The implementation in Hungary of the new capital requirement rules will however, entail even more difficulties owing to their complexity and complicated nature as well as to the fact that they rely heavily on the Anglo-Saxon system of legislation.

For this reason, the following is a collection of the most important elements that may entail difficulties in relation to the implementation of the Directive in the existing Hungarian regulatory and market environment. Since the HFSA is not an institution drafting laws, it has put out the enclosed materials for consultation by a wide range of stakeholders, to get to know the opinions of the regulatory authorities and market participants about the questions raised, and thereby to identify any other problem areas.

The problems to be encountered fall in the following main categories:

- I. Issues relating to credit risk mitigation
  - legal enforceability of collateral
  - netting agreements
  - other issues (seniority, separate mortgage rights)
- II. Interpretation of interest accruals
- III. Issues relating to provisions on data protection
- IV. Rules on rating assets and off-balance sheet items
- V. Supervisory discretionary decisions
- VI. Market circumstances

The comments received in the course of the consultation process confirmed the HFSA's problem identification and they raised additional questions particularly with respect to the interpretation of the provisions of the Directive in the Hungarian regulatory environment. Processing those questions is in progress.

## **5.1 Questions relating to credit risk mitigation in the new capital requirement directive**

Upon the entry into force of the new European capital requirement directives the existing European directive concerning instruments applied in credit risk mitigation will be altered. The range of risk mitigating instruments that may be recognised when the standardised method is applied, will be supplemented by netting agreements and credit derivatives that meet the relevant criteria, and the requirements to be met by the currently recognised financial collaterals and guarantees will also be changed.

The prospective changes in the regulations make it necessary to review the Hungarian regulatory environment from the aspect of the types, extents and depths of modifications that will be necessitated by the adoption of the new capital requirement directives. In the area of credit risk mitigation the issues to be faced include, among other things, providing for the possibility to collect receivables from collaterals by force of law as prescribed in the Directive, tasks relating to the adoption of new forms of netting arrangements and other issues affecting domestic market practices. As a matter of course, an increasing number of issues are raised by market actors as well as regulators as they are making progress in understanding details of the Directive. This paper is not aimed at discussing and resolving all of the issues, instead, we are making a proposal for the settlement of issues raised so far, as listed above.

### **5.1.1. Legal enforceability of collection**

Provisions concerning the legal enforceability of collateral security items are included among the criteria laid out in the new capital requirement Directive for the recognition of credit risk mitigation instruments. The Directive stipulates that the credit risk mitigation impact of collateral security items can be recognised in the calculation of the regulatory capital requirement only if the collateral contract makes it possible for the lending credit institution in case of default, insolvency or bankruptcy of the borrower, to keep or liquidate the collateral security items, i.e. to directly settle its claim and collect the price of the collaterals within an acceptable time frame.

The currently effective provisions of the Bankruptcy Act do not meet the requirements laid out in the Directive since the liquidator has to pay only 50 % of the purchase price received from the sale of the mortgaged items (net of the costs of sale) to the obligee credit institution (Article 49/D (1)). The amendment to the Bankruptcy Act in early 2004 (Act XXVII of 2004) however, resolves this issue in a satisfactory way with respect to financial collaterals, by adopting Directive 2002/47/EC on financial collateral agreements.

#### *Financial collaterals*

Article 38 (5) of the Bankruptcy Act in effect since May 2004 the obligee may, as specified in Article 271 of the Civil Code, have his claim settled from the bail regardless of the launching of the liquidation process, and only after this has the remaining amount to be handed over to the liquidator. Article 271 of the Civil Code - also amended - provides that upon the accrual of its right of settlement (i.e. in the case of default, insolvency or bankruptcy) the obligee may have its receivable secured by a bail settled directly from the bailed asset if the bailed asset is an amount of money, credit balance on a bank account, or

securities with publicly listed market price or with a price that can be established otherwise at the given point in time, independently from the parties concerned. This wording applies to the asset that can be recognised as financial collaterals by the new capital requirement Directive. On the basis of the above justification, therefore, in our opinion, the criteria for recognition concerning the possibility of collection by force of law as prescribed in the Directive with respect to financial collateral, are also provided for in the relevant Hungarian regulations.

#### *Other collaterals*

In methods based on internal rating, in addition to financial collaterals it is also possible to recognise real estate collaterals (both residential and commercial property), receivables and other physical collateral security items, if specific requirements are met. These types of collaterals, however, are subject to the above mentioned regulation, i.e. that the liquidator is obliged to pay 50 % of the purchase price received from the sale of the mortgaged items (net of the costs of sale) to the obligee credit institution. And this provision is not in line with the minimum requirements of the Directive detailed by type of collateral, linked to the possibility of settlement by force of law, so upon the adoption of the Directive this will have to be amended. Should these amendment proposals fail to be implemented by the deadline for the mandatory transposition of the Directive into the Hungarian law, its consequence would be that such collateral security items could be taken into account as capital requirement reducing items only to a limited extent, that is, higher risk weights would have to be applied for receivables covered by such other collaterals, than in other EU Member States. This would have a particularly serious impact on lending under real estate coverage.

### **5.1.2. Netting arrangements**

One new feature of the new EU capital requirement Directive concerning netting is that from its entry into force, in addition to netting arrangements concerning off-balance sheet items, that have been recognised to date in the calculation of the regulatory capital requirement, some netting arrangements concerning deposit and credit transactions within the balance sheet (on-balance sheet netting), meeting certain criteria can also be recognised, along with master netting agreements affecting capital market transactions recorded in the banking book.

In the course of the implementation of the Directive the adoption of these forms of netting arrangements in the Hungarian regulation should be considered and at the same time the satisfaction of the legal requirements relating to their application should be examined.

At present the European regulation permits the application of netting arrangements for off-balance sheet items, and this is applied widely in EU Member States in the form of master netting agreements (frame contracts). Although the Hungarian regulations also permit their application, this is hindered in practice by the fact that the criterion - that is supervisory approval of such netting agreements - required for application is not met (see below). General permission of master netting agreements is also an important issue in relation to the adoption of the European revision of the regulations on the trading book, therefore the sector is calling for permission as soon as possible. The Hungarian Banking Association has notified the HFSA that a Hungarian 'Master Netting Agreement' was elaborated - by an organisation commissioned by the Association - last year for the netting of off-balance sheet items, a Hungarian version of the 1992 ISDA standard. The HFSA will review the proposal and if the necessary requirements are met, it will accept it as a master netting agreement.

On the basis of the new Basel recommendation and the European Directive agreements for netting between credits extended to and deposits placed by a given partner will become eligible instruments reducing credit risks in the calculation of the capital requirement, if they meet the following criteria:

- the agreement can be enforced by the laws of all countries concerned, even in the case of the insolvency or bankruptcy of the counterparty;
- the credit institution is always capable of identifying the claims/liabilities involved in netting with the counterparty concerned;
- the credit institution monitors and manages the risks relating to the close-out of netting;
- the credit institution monitors and manages its exposure on a net basis.

In the case of this type of netting agreements, on the basis of their legal requirements the close-out requirements or the requirements pertaining to position (close-out) netting arrangements under any other title, are met, ensuring that in the case of default on the part of the counterparty (or in the case of the occurrence of other events giving rise to cancelling the arrangement as specified in the agreement) the credit institution can impute the deposits of its partner, thereby reducing the amounts of its receivables from the partner. Such netting arrangements are already applied in the interbank market of Great Britain, with BBA's recommendation.

In the Hungarian regulation on-balance sheet netting could be made applicable by an adequate amendment to the Bankruptcy Act, which would enable meeting the criterion for enforcement by law.

The new directive also adds to the types of netting arrangements that can be recognised in the course of the calculation of capital requirements, master netting agreements in the trading book relating to repurchase agreements (repos, reversed repos) and/or commodity or security lending transactions and/or other capital market driven transactions. The criteria for recognition in this case again include the legal requirements ensuring (position) close-out netting, which are already included in the currently effective international and the related Hungarian regulation. Based on the Directive the position close-out netting arrangement as specified in the capital market act (Article 5 (1) 87.) - which will be reviewed upon the transposition of the Directive - corresponds to the concept of netting that can be recognised in the regulatory capital requirement.

*'position closing netting': based on the agreement between the parties, upon non-performance of the contract or upon the occurrence of other event giving rise to cancellation as established by the parties, conversion into a single net debt or receivable of debts and receivables originating from prompt forex and securities transactions, derivative transactions, repo or reverse repo transactions, agreements concerning the lending of securities, other contracts serving bail or collateral purposes, or from other similar financial transactions, in the way of settlement accepted in the market of the given financial product, as a consequence of which the debt or receivable is exclusively limited to the net amount so established;*

In the effective Hungarian regulation the concept of position closing netting is covered by a rule in the capital market act providing that the application of position closing netting to items in the trading book requires approval by the HFSA. The HFSA approves a netting agreement if by examining the contract it has found that there is no legal impediment of automatic and prompt offsetting of claims against liabilities and that the internal regulations and procedural regime of the institution ensures permanent monitoring of the legal conditions of the agreement.

Accordingly, this concept that has already been introduced in the Hungarian legal system with respect to netting agreements to be approved in the future should be extended to items in the banking book, so as to make it possible to be applied in practice in the market, contributing to the development of the markets and the improvement of liquidity.

Provisions concerning the legal enforceability of position closing netting already appear in the currently effective Bankruptcy Act (Article 36 (2): ‘... in the case of an agreement for position closing netting the lender has to report the net receivable to the liquidator and the liquidator enforces the net receivable ...’), whose amendment in May 2004 provided for the adoption of the provisions of Directive 2002/47/EC on financial collateral agreements. The new directives confirmed the legal enforceability of position closing netting agreements.

It should be noted in general that the legal mechanisms of the netting agreements to be recognised in the new directive corresponds to that of position closing netting, the only relevant difference being in the transactions that constitute the subject of the netting agreements. In this way the position closing netting concept introduced in the Hungarian regulation is suitable for introducing agreements pertaining to newly recognised banking book items in the Hungarian regulation, which may be accompanied by additional regulations required for application.

In the Hungarian terminology recognition of netting agreements from the aspect of capital requirement calculation appears in the capital requirement calculation for trading book positions (Government Decree 244/2000 (XII. 24.) Article 2 (1) 25.):

*‘netting agreement’: a contractual clause or a separate agreement concluded in a way accepted by the HFSA, reducing counterparty default risk, covered by collateral, under which*

- a) collateral can be enforced (collected from) promptly and unconditionally,*
- b) the legal bases of the receivables originating from the relevant financial operations are identical,*

- c) the receivables are settled at regular intervals during the effective term of the contract and*

- d) the liability remaining after settlement applies from that point on, to the new net amount;*

As a consequence of the above, the above concept of netting arrangements includes in this case the elements of payment/settlement netting/novation) and those of closing netting as well.

It should be noted that in relation to the new capital requirement directive the review of the currently effective regulation of trading book items is in progress, which has a substantial impact on the treatment of netting agreements from the aspect of capital requirements as well.

### **5.1.3. Other issues**

#### *Seniority*

One of the problems to be faced in the course of the implementation of the new capital requirement Directive is that the lack of legal regulation of junior/senior credit permits the interpretation that all exposures qualify as junior. In this case when applying the basic internal rating method the loss ratio (loss given default, LGD) will be 75% instead of 45%,

substantially increasing the calculated capital requirement. The interpretation - that is favourable for credit institutions - according to which all receivables are senior except for subordinated loan capital as specified in the Hungarian law, is not quite clear, since at certain points the Directive refers to seniority, while at other points it refers to items not qualifying as subordinated loan capital, thus clearly distinguishing these two types of claims from one another. Judgement of whether an item is senior or not may be linked to the order of settlement as provided for in the Bankruptcy Act, so this issue definitely needs to be clarified in the course of drafting the relevant regulations.

#### *Treatment of separate mortgage rights*

The draft Directive does not cover the treatment of separate mortgage rights from the aspect of the capital requirements, for this is a special Hungarian legal term. Raising the question is justified by the fact that according to the provisions of the Directive, in the standard method mortgage credit institutions weight receivables they are refinancing by the weighting factors applied to exposures to institutions (50%), or to exposures covered by residential real estates (35%). A review of the contents of the transaction and the concrete scrutiny of contracts is in progress, on the basis of which the HFSA will make a proposal for weighting that can be applied in the regulation.

## **5.2. Interpretation and treatment of interest accrual in the new directive**

The basic problem in relation to the treatment of interest accruals in the new regulation is that according to the Directive 'non accrued interest' means non-performance, that is default, in the application of capital requirement calculation by the internal ratings based approach. According to the Hungarian accounting rules in the case of an item past due by more than 30 days, the interest has to be put on a suspense account and this would reduce the default time limit to 30 days, in comparison to the 90 day definition applied in the Directive. The HFSA is in favour of the 90 day default definition, i.e. it considers that the statutory requisites for this should be provided for. Several possible ways seem to be available for resolving the issue, for instance, only interest categorised as 'non accrued' beyond 90 days should qualify as default, or interests should be categorised as 'non accrued' only beyond 90 days.

After a review of the problem the HFSA is in favour of the proposal that interests not received 30 days past due should continue to be categorised as 'non accrued' on a mandatory basis, but from the aspect of capital requirement calculation only an exposure outstanding even after 90 days past due, should qualify as default. (This interpretation has also been presented on the basis of the Directive in other European countries.)

Rendering interests 'non accrued' is accompanied by another problem that will appear in the course of the adoption of the new regulation. According to international accounting standards interests not received are booked by credit institutions as interest revenue, at the same time generating a 100 % provision for them. The accounting treatment of interests has an impact on the amount of capital required for covering the operational risks, which is based on interest revenue, and which cannot be reduced by provisioning. For this reason, by way of rendering interests 'non accrued', the Hungarian regulation improves the situation of the institutions applying the simpler methods (basic ratio and standard method) of the establishment of the capital requirement of the operational risk, than the requirement of 100 %

provisioning as customary in other EU countries. Although the European Directives do not regulate precisely the way interests not received (past due) have to be treated in the accounts, so the Hungarian regulation is not contrary to the EU directives, but the Hungarian regulation may be contested by others by arguing that Hungarian credit institutions and investment firms are enjoying an unjust advantage in competition.

### **5.3. Issues relating to the provisions on data protection**

In the more advanced methods applicable in establishing the capital requirement of credit risks the institutions calculate their regulatory capital requirement on the basis of estimates relying on their own rating systems. The internal rating system relies, in turn, on databases containing existing and/or continuously growing sets of information on customers. The issue of setting up such databases - since this involves controlling personal data of customers - necessitates review of the currently effective Hungarian personal data protection regulations in order to make it possible for institutions to set up and operate databases providing adequate support to the calculation of capital requirements based on the advanced methodology, without violating rules on data protection.

In the Hungarian legislation protection of personal data is provided for by Act LXIII of 1992. The question therefore is how it is possible to introduce advanced methods in Hungary in concert with this Act, when these methods require the collection of a much wider set of data on customers than before. The act on the protection of personal data permits controlling personal data (recording, storing, processing and utilisation - including transmission and publication - of data) only for specific purposes, and only personal data that are indispensable for attaining the given purposes, may be controlled. And data controlling is permitted only if the data subject (customer) has consented to it or if this is prescribed by law or local governmental decree. Although both the act on credit institutions and investment firms and the data protection act provide for the transmission of data to third persons, but this is permitted by both acts in strictly regulated cases. The problem is that the consent of the data subject cannot always be obtained (in the case of using historical data series), and it would be difficult to specify by law (should the regulator commit itself to do so) the range of personal data that can be controlled for this purpose. A list would not be a suitable solution in this case for that would put a restriction on the development of rating system and it would be well-nigh impossible to specify the types of personal data that can be suitable indicators of risks, in a regulation (this should be decided individually by the institutions themselves). In relation to this it is also necessary to establish the extent to which information obtained about the customer qualifies as personal data in the course of the operation of the database and in producing estimates, i.e. to which point are data suitable for identifying the individuals concerned.

Another issue of data protection is the provision of the capital requirement Directive according to which in assigning exposures to the retail category a credit institution has to aggregate the exposures of the customer to the members of the group the amount of which - to the knowledge of the credit institution - must not exceed EUR 1 million (if it does, it has to be assigned to the corporate category and has to be subject to a higher risk weight). Accordingly, the credit institution has to take 'reasonable steps' to learn about the amount concerned. Under the Hungarian data protection regulation this provision is difficult to interpret, the practical restrictions of which may be encountered even in international relations.

Difficulties relating to the transmission of data may also appear among the international aspects of data protection issues: in the case of groups of credit institutions

operational on an international plane calculations based on standardised data collection necessitate transmitting personal data abroad. This is permitted by the Hungarian regulations only if the data subject has consented to it and the country where the foreign data controlling entity is operational has data protection regulations in place that meet the Hungarian data protection requirements.

The possibility of transmitting data within a group in the territory of the Republic of Hungary also entails some problems. One example for this may be a subsidiary set up to collect non-performing receivables, which currently cannot return recovery data relating to the effectiveness of collection, to the parent institution. From the aspect of capital requirement calculation, however, these data need to be accessible for estimating the loss ratio.

These issues are not unique to the Hungarian system of legal regulations, other European Member States also have pointed out that it is necessary to modify data protection regulations restricting data collection for capital requirement calculation and to resolve contradictions in some way. Such a commitment should be declared at a European level to provide the national legislation systems of the Member States with a basis of reference. Accordingly, German experts have proposed that a reference to Directive 95/46/EC regulating issues of data protection at a European level should be incorporated in the text - the preamble - of the Directive containing the new capital requirement regulation, which was adopted by the Council in December. The purpose of the reference so incorporated is to ensure that in applying Directive 95/46/EC in their national legislation the Member States do not restrict data protection and controlling for the purposes of risk management and capital requirement calculation excessively and in an unjustified way ('unduly limit the availability of data').

Resolving the issues relating to data protection, though it does not appear to be a highly important area, may have a substantial impact on the successful introduction of the new capital requirement regulation. The European regulation of data protection issues allows ample manoeuvring room for national legislators, as a consequence of which national data protection regulation may itself also become an important factor in the effective application of the new capital requirement regulation. As a matter of course, a flexible interpretation of the data protection regulations with respect to data controlling tied to a given purpose (risk management, capital requirement calculation purpose), cannot result in reducing the level of protection of personal data, therefore the Hungarian data protection regulations need to be reviewed and a solution has to be proposed that is suitable for resolving in a satisfactory way the above problems and other similar potential problems without violating personal data.

#### **5.4. Minimum requirements concerning the rating system, in the internal ratings based approaches**

There is a wide range of minimum requirements to be met in relation to the application of the capital requirement calculation methods based on internal rating, that are to be introduced by the new capital requirement Directive. Such minimum requirements pertain to the structure of the rating system, the criteria to be applied in the course of rating, to the assignment of exposures to rating categories and the integration of the rating system in the risk management process.

Since the provisions of Decree No. 14/2001. (III. 9.) PM - currently in effect in Hungary - on the criteria of the rating and evaluation of receivables, investments, off-balance sheet items and collateral security items pertaining to the rating of receivables and of debtors,

are substantially different from the Basel and EU requirements to be introduced, preparations for the modification of this decree should be started at this point already, in order to ensure that such differences do not hinder the preparations of institutions (such requests have already been submitted by institutions to the HFSA). Amending the rating decree as soon as possible is also necessary for the Directive also calls for the completion of an application testing period of at least a year, for institutions introducing these methods. Accordingly, in order for institutions to be able to meet the requirements, they need to know the future amendment to the rating decree as soon as possible.

The HFSA is working on this, the working paper concerning the validation of rating systems and the supervisory approval of advanced methods will be published in the near future.

## **5.5. Supervisory discretionary power**

Owing to the regulatory cultures, different interests and special feature of the various countries, neither Basel nor Brussels managed to close a number of questions for good, as an inevitable consequence of which both the Basel recommendation and the draft Directive contain a number of references on the basis of which the various countries or supervisory authorities may decide, in their own scope of competence, about concrete application of certain rules. Such discretionary decisions are, perhaps, one of the most serious threats to the standardised application of the recommendation and the Directive, since it is very difficult for global financial groups to calculate capital requirements on a consolidated basis, if detailed rules differ from country to country. This problem is particularly serious in the EU where in the European internal market a regulatory arbitrage possibility can be utilised at much smaller collateral costs than in the case of countries outside the Union, where borders constitute real barriers. For this reason, primarily in the framework of the Committee of European Banking Supervisors (CEBS), the banking supervisory authorities of the European Union are working on supervisory standards, interpretations and on a significant reduction of the number of discretionary decisions, whose primary goal is to attain a higher degree of supervisory convergence. The commitment to and the depth of the efforts made to attain convergence is also indicated by the fact that there is a project in quite an advanced stage whose aim is to enable the supervisory authorities of the EU to ask for reports of the same content and format about meeting the new capital requirement directives in each Member State, thereby reducing the extra burdens caused by differences in reporting services.

The system of discretionary decisions poses a problem for Hungary from another aspect as well. The problem is not as grave in the case of the issues to be decided on a national level, since these will be contained in legal regulations. The system of supervisory discretionary decisions is, however, still quite unusual in the Hungarian legal system, despite the fact that recent years' steps in financial legal harmonisation have loosened the earlier strict German type legislation in a number of points. In respect of the system of legislation, in addition to the national discretionary decisions, a substantial part of the supervisory discretionary decisions will also be worked out in legal regulations in Hungary, at the same time some of the new frameworks will necessarily include elements that can be managed exclusively through supervisory discretionary decisions. Considering such rights can be exercised in many cases only on the basis of information that cannot be quantified, such powers should be specified for the HFSA at the level of legislation.

## 5.6 Market circumstances

The new directive creates new foundations for capital requirement calculation by the standard method which is already in use. Accordingly, by replacing the administrative type categorisation, the standard weighting regime will also be more risk sensitive, since the weighting factors will be based on the external rating of the partner. However, in countries where there is a small number of rated institutions and undertakings - as for instance in Hungary - this method cannot be implemented in line with the purpose of the regulation because weighting applied to exposures without external rating (that is, the majority of cases), will not be suitable for adequately showing the underlying risks.

A significant proportion of commercial banks in Hungary are planning to introduce the method based on internal rating, under guidance provided by their parent institutions. Applying the method requires meeting a wide range of minimum requirements referred to in the Directive, some of which may entail difficulties. One of the most important requirements is to have data series of adequate quantity, quality and length. In Hungary, in many cases the small number of customers and/or the small number of default data practically prevents in some exposure categories the development of a rating system based on such data. To resolve this problem subsidiaries are planning to apply estimates calibrated on the basis of group level databases containing their own data as well. The application of such estimates, however, may be questioned from the aspect of supervision, since such estimates do not necessarily reflect the domestic risk conditions. It should be noted that this problem is related primarily to the quantity of data, not so much to the quality of records. One solution for this may be where the institution determines the parameters of capital requirement calculation based on a model developed globally for the given group, and can prove by adequate methods that the database is representative of the portfolio of the given institution.

The application of the internal rating method is facilitated in some countries by positive debtor lists. This huge database could provide very substantial assistance for institutions in Hungary as well, concerning rating and it would probably improve the precision of the estimates of the probability of defaults. Such types of databases are already in operation in other member states, in concert with the EU rules on data protection. Accordingly, this is not restricted from the aspect of the European Union, so such an institution could and should be set up in Hungary as well.

The application in Hungary of the internal rating method may also be influenced by the special feature of the Hungarian market that is characteristic of the Hungarian corporate sector. The Directive draws the line between small and medium sized enterprises and the corporate exposure category at amounts that are very high in the Hungarian circumstances, as a consequence of which the corporate category may be left without customers, and many customers are shifted to the retail category. A possible solution could be reducing the limit amount in the Hungarian regulations but that could lead to problems in the calculation of consolidated capital requirements by groups with parent companies abroad. This issue is also linked to the problem related to the database, since in this case the institutions would have to set up their corporate rating systems on the basis even smaller numbers of customers. As a result of the examination of the issue, having assessed pros and cons of applying the limit value specified in the Directive, the HFSA is in favour of adopting the EUR 1 million limit value specified in the Directive, into the Hungarian regulation.

One of the most widely practised way of reducing credit risks is covering exposures by real estates. This applies to the Hungarian market as well, but the slowness of the process of entering real estate mortgages in the register has a negative impact on conducting transactions of this type. The minimum requirement required for recognising the risk reducing effects of

real estates as specified in the Directive - enforceability by law - is also related to this, which is not fully provided for Hungarian credit institutions owing to the special characteristics of the currently applied liquidation procedures. Improving these conditions is definitely necessary to enable recognition of the risk reducing effect in the calculation of the regulatory capital requirement and to improve its effectiveness.

Another special feature of the Hungarian market relating to credit risk mitigation is that we have no adequately liquid securities markets and the depth of the existing ones is not quite sufficient. There is a small number of papers on the exchange, which adds to the risks of such exposures.

The regulatory background of securitisation transactions has to be properly developed in the Hungarian market: this may be created together with the introduction of the new regulation. The difficulty of the task is increased by the fact that this type of transaction has been almost entirely unknown in the Hungarian market until recently.

With respect to the large number of savings cooperatives in the Hungarian financial market, which are particularly active in retail lending, the HFSA also considers it necessary to give a proper interpretation to the provisions of the new regulation. The Directive extends the scope of the new capital requirement regulation to this type of institution as well, at the same time it lays down the principle that the provisions of the Directive have to be applied in view of the principle of proportionality. This issue appears in a critical way particularly in two areas in the course of the application of the Directive: the interpretation of the criterion of numerosness concerning the retail portfolio and the supervisory review of the internal capital adequacy assessment carried out by the institution. The situation of the domestic savings cooperatives is, however, not unparalleled in the Union, therefore these issues are also being worked on by an international working group. The guidelines of this working group will also be applied by the HFSA besides the aspects of the domestic market participants.