

Actions Planned and Carried Out by HFSA to Improve the Efficiency of Consolidated Supervision

Annexes

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1 Introduction

Three powerful trends have had a considerable influence on and have been changing the shape of international money markets and the financial products and services provided through them for a decade now: **globalization, fast and quite productive financial innovation, furthermore, the dynamic propagation of transactions and products that reach beyond individual financial sectors. These have restructured and reshaped the whole arena of money markets and supervision has to catch up with that development.** Globalization has washed away national boundaries and the obstacles associated with them equally in the competition, in the flow of capital, in financing and spreading new products and new types of transactions. Innovation has been extremely fast and is manifest in the ongoing renewal and expansion of product lines. With the increasing economic importance of cross-sector transactions the strengthening of business and ownership relations reaching beyond the boundaries of individual financial segments (credit institutions, capital markets, insurers and funds) is noticeable in Hungary, just as throughout the world (partly as the engine of the change and partly as its expedient institutional basis). **Financial conglomerates have been set up that offer almost all financial services available in the financial sectors involving several enterprises under the umbrella of a single group. These developments necessitate the unified and consolidated treatment of the financial sector for all concerned parties; service providers, clients, and especially supervisory authorities.**

In the international practice of financial services supervision these developments led to an obvious shift toward consolidated supervision that covers the entire financial sector. In some countries this has been solved by strengthening institutional cooperation between the individual sectors' supervisions (The Netherlands and France), elsewhere by setting up integrated supervisions. One outstanding example for the latter solution is the foundation of the British FSA, which was created by merging nine, previously separated supervisory authorities, however, the trend of moving toward setting up integrated supervisory authorities is clearly evident in other countries as well (including Germany, Ireland, Austria and the Scandinavian countries). In that respect in Hungary the most important step was the foundation of HFSA in 2000, which meant the fusion of the former Hungarian Banking and Capital Market Supervision, the State Insurance Supervision and the State Private Funds

Supervision, already preceded by the merger of the State Banking Supervision and the State Securities and Stock Exchange Supervision.

2 Market Environment

The effects of **the concentration of the international money and capital markets** are also apparent in the Hungarian markets. The main areas of this concentration in our respect are:

- Concentration crossing sector boundaries. This is manifest in the fact that the supervised service providers expand their activities covering several financial sectors and merge their institutions that used to operate independently in the different sectors. They do that to increase their financial power, improve their market position, increase their products' competitiveness, to exploit the potentials in the economies of scale, and last but not least to take advantage of the opportunities arising in the regulatory arbitrage. The HFSA can meet the resulting challenge by **developing the tools of consolidated supervisory activities and group supervision and introducing new technologies and devices that efficiently support these activities.**
- Cross-border concentration within sectors resulting from acquisitions. A significant proportion of the institutions supervised by us is more or less associated with foreign companies, or groups of companies through their owners, and these have some degree of influence over their activities. **We must also be capable of dealing with foreign connections** in the course of the supervisory work. This considerably **appreciates the value of our international connections, especially the HFSA's place in the European integration, our bilateral supervisory cooperation and the efforts made to develop them.**

Legislation had already opened the opportunity of **universal banking** for credit institutions that is they have been allowed to provide investment services. Since then supervision must be able **to cope with the risks that arise from that and the cumulated risks, to treat all credit institution risks in a consolidated manner** and to supervise the credit institutions' risk management, which is a typical example for supervision on a consolidated basis. The fundamental means for all of the above is the trading book, introduced equally in all sectors, i.e. it stipulated identical capital requirement to cover market risks for all investment service activities. The **trading book** helps to separate risks and to confirm the existence and

adequacy of the capital allocated to provide cover for them. Investment firms must also keep a trading book. HFSA played an active role in drawing up the rules pertaining to the trading book, adopting the principles of the European Union and introducing the trading book. The HFSA also offered help to financial players.

In a broad range of financial organizations **property and deposit management**, both as **services in support of their own activities**, like in case of funds, investment funds, and as commercial services, like deposit management provided by banks, has an important function. **We can only control the activities of the supervised organizations comprehensively**, i.e. adequately, if **we investigate such used and provided services together with their other activities**. Supervision on a consolidated basis makes that possible.

The former, sector based supervision **of funds** did not extend to **property management** by external service providers, even though that had a considerable influence on their profits, thus securing yield to fund members. Consolidated supervision is suitable for including this fundamental element within the sphere of investigative competence.

Insurance services are being increasingly intertwined with banking and investment services. Unit linked life insurance offers a typical example for that. It follows from their complexity that such activities and the associated risks can only be properly controlled by consolidated supervision. The Insurance Act already makes it possible for insurers to offer mortgage loans on a limited scale.

Business deals in which certain financial organizations offer **agency services** to other financial organizations, like home savings banks sell banking products together with their own as agents, are also widespread. In supervising such organizations that provide or use agency services **only supervision on a consolidated basis is capable of appropriately discovering linkages and transferred or cumulated risks**.

Originally, actuarial activities were designed for insurers and supervisory control of the actuaries' work also focused on insurers. Today pension funds must also employ actuaries and for that reason the **supervisory control of actuarial activities had to be extended to this professionally different field as well**. In order to do that the supervision of actuaries' work and funds had to be consolidated.

In the supervision of these and similar activities, products and the organizations offering them the **basis of consolidated supervision is that investigations are grounded on the**

development and employment of integrated procedures and integrated methods, implementing appropriate cooperation and information exchange among participants.

3 Measures Taken since the Foundation of HFSA

Since the most important objective of the fusion in 2000 was to improve the efficiency of consolidated supervision, the management of the unified supervision has also defined that as one of the most important tasks. Accordingly, in the past two years several steps were made that contributed substantially to developing the supervisory methodology of financial conglomerates.

HFSA's management **has identified making the operation of the financial sector more reliable and strengthening the confidence of economic players in this sector as the primary strategic objectives.** The management has selected the **implementing consolidated supervision, putting much more emphasis on the preventive nature** of supervisory work and **moving to risk-based supervision as the three fundamental building blocks.**

3.1 Developing and Publishing the Principles of Supervision

Not long after its foundation HFSA prepared and published its document outlining the principles of supervision. The principles pointed at the development of consolidated supervision, equal treatment of the different sectors and setting up a risk-based supervisory system as the basic objectives. Since the publication of the basic principles HFSA has prepared all its methodological papers (supervisory policy, inspection programs, recommendations, guidelines, methodological guidelines and internal procedures) on the basis of those principles.

We have based the development of our activities and the order of **procedures on four basic principles** that also serve as the principles for the new Supervisory Authority's general behavior and for all of its activities. These are:

- **strengthening the confidence in the supervised sectors and service activities;**
- **informing market players and preparing them for the future;**
- **protecting consumers; and**
- **reducing illegal activities.**

We also conducted multifaceted domestic and international consultation in the course of developing our principles and relied on international experience concerning advanced solutions. Among others we have built upon the experiences of the International Monetary Fund, the Basel Committee on Banking Supervision, and the British, Swedish and German supervisory authorities. The definition of the principles considerably contributed to making the supervisory methods developed by the predecessor supervisory authorities more unified. **Supervisory approach based on equal principles is an important element of consolidated supervision, as it ensures that the HFSA treats the enterprises that belong to the same financial conglomerate and deliver different services equally.** During the first few months after the fusion it soon became clear that the predecessor supervisory authorities employed different methods and had different supervisory cultures. The unification of supervisory methods **has made it possible** for the HFSA **to conduct group-level inspections**, to go beyond merely checking statutory compliance also in sectors outside of credit institutions, furthermore, to put emphasis on discovering the risks present in the supervised institutions and to assess risk management and internal audit systems not only in quantitative terms, but also qualitatively. This change in perspective was a prerequisite for HFSA **to conduct preventive supervision** in line with the expectations emerging from international practices (e.g. Basel Committee on Banking Supervision, or IOSCO).

A central element of the continued development of supervisory activities is the current project aiming at the development of inspection manuals describing the detailed processes of investigation in each and every sector. In addition to helping supervisory efforts in the individual sectors the inspection manuals also help HFSA in treating identical activities and identical risks using the same principles and methods.

3.2 Strengthening the HFSA's Independence

International standards pertaining to supervisory activities assign primary importance to the requirement of supervisory independence in all sectors. In Hungary prior to the fusion of supervisions the individual predecessors had substantially different degree of independence, which difference was primarily grounded on the predecessor status (with the exception of the State Banking Supervision all predecessor organizations operated under the Ministry of Finance and were financed from the central budget). The predecessor organizations' resolutions within the Ministry of Finance could be contested through the Minister, while this is only possible through the courts in case of HFSA. With the establishment of the integrated

supervision the independence of the rest of the predecessor organizations was significantly increased on the one hand (today HFSA has an independent budgetary chapter financing itself exclusively from its own revenues and not from budgetary subsidies), while on the other hand the act regulating the status of HFSA was successfully supplemented with guarantees (such as the conditions of appointing and recalling the president) by way of which Hungary has met the international professional requirements. Additionally, our upcoming accession to the EU lends special importance to compliance with international standards, especially with the requirement of supervisory autonomy: the Brussels Committee has already paid special attention to the earliest possible implementation of supervisory independence in relation to our entrance to the unified market. A unified, independent and integrated supervision is a lot more authentic and equal partner in supervising financial conglomerates with enormous economic power, than the former supervisory organizations could have ever been. Although, substantial progress has indeed been made with respect to the HFSA's independence, it still has not been granted the right to issue supervisory decrees, which could be of further assistance in finding its place among the supervisory authorities of EU member states.

3.3 The Development of HFSA's Organizational Structure

The organizational structure of integrated supervisions can be implemented following one of three fundamental models. The first is division by sectors according to which the organizational units are set up to reflect the supervised sectors (credit institutions, capital markets, insurance services and pension funds). The second is the functional structure according to which the organizational units are set up according to the activities performed (licensing, enforcement, or supervision, etc.). The third possible solution is the matrix structure in which an attempt is made to combine the above two versions.

HFSA's organizational structure most resembles the matrix structure. In defining the organizational units making them support consolidated supervision as much as possible was a prime consideration. For that reason functionality is a guiding principle of the organizational structure, thus all specialists of licensing, enforcement and supervision have been gathered within one organizational unit (directorate), thereby improving the flow of information both to decision makers and executors and ensuring that the individual resolutions are based on unified principles. Supervisory advisors are in charge of coordinating supervisory work related to sectors in HFSA's organizational structure, as a result of which information flow and coordination are achieved both vertically and horizontally.

Prior to the fusion of the predecessor authorities the supervision of credit and financial institutions, investment firms and insurers that belonged to certain financial conglomerates was not coordinated at all. With the establishment of HFSA and the optimal organizational structure that situation has fundamentally changed, as a result of which today on-site inspections are planned and inspection programs are set up ensuring that the on-site inspection of institutions that belong to the same group is done simultaneously and the conclusions of the inspection cover not only the individual institutions, but the entire group as well. **Today the HFSA's measures are not based merely on the risks associated with individual institutions, rather the risks are aggregated on group-level and thus potential group-level problems threatening the individual institutions can also be taken into consideration.** In addition to applying this principle to the complexities of ownership and control in financial conglomerates, HFSA extends it to institutions, which, although not tied together by proprietary relations, are engaged in business relations which substantiate the threat of spreading one institution's problem to the other (e.g. funds' service providers, especially portfolio and deposit managers).

The technical basis for controlling supervised organizations in different branches on the basis of equal principles, in light of the economic links and interrelationship between them, **following a unified concept** that is required for **solid, consistent and dependable supervision** has been laid down by the organizational and technological advances. There is a qualitative advantage in supervising the entire sector **with a comprehensive approach in a consolidated manner**, which substantially improves the efficiency of identifying risks. The key elements of consolidated supervision are:

- supervisory activity that extends to the entire financial sector and efficiently monitors the service providers' compliance with legal requirements (including on- and off-site supervisory work);
- monitoring, rating and analytic system that covers the entire sector and offers efficient support to preventive supervisory efforts;
- consolidated supervision adequately reflecting the economic relationships, interrelationships and interferences between the service providers operating in the sector's different branches, which
 - offers a good overview of the entire market and its internal processes and handles them efficiently;

- is capable of discovering the risk factors inherent in the ownership and business interrelationships between service providers operating in different branches and of preventing their adverse effects;
- supervises, analyses and assesses their work using the same standards and with the same thoroughness;
- is capable of intervening at the same level of efficiency anywhere in the entire sector, in all of its branches, well handling the links and connections between the branches.

A new and qualitatively superior method of our consolidated supervision is **group-level supervision**. The application of consolidated group supervisory methods concentrating on entire financial groups **makes possible the proper assessment of groups' total risk, the identification of additional and hidden risks** arising from the economic relations between group members and the **reduction of the chance of regulatory** arbitrage possible. Group-level supervision is an efficient tool for discovering and preventing business practices that aiming at hiding the risks by some financial companies and, which constitutes one of the most severe risks to the financial sector. They do it, for instance, by having closely controlled institutions move their risky contracts to a less regulated, or supervised institution. At the same time the efficient employment of consolidated and, especially, group-level supervision calls **for the continued development of statutes pertaining to the supervised service providers, activities and to the HFSA itself**, concerning which we have made initiatives. These initiatives have primarily aimed at the harmonization of sector level legislation, elimination of former inconsistencies and, simultaneously, closing the door before regulatory arbitrage. In that respect the integrated HFSA's understanding of the statutes as a whole and its authenticity are much better, than before. The group-level provisions pertaining to prudential activities also contribute to the implementation of the practice of consolidated supervision. Enforcing compliance with these provisions and monitoring risk management systems HFSA may assess the risks hidden in groups' activities and their potential effects on group members beyond individual supervision.

3.4 Setting up a New Supervisory Framework

Serious obstacles had to be removed in order to set up the integrated supervision, an important supervision-technological innovation in the frontline of development even by

international standards, and several other steps are yet to be taken in order to optimally exploit all of its potentials. Its expediency and success have been clearly reflected so far by the experiences related to the HFSA's role in ensuring the market's reliable operation. Furthermore, the feedback received from home and from abroad plainly confirms that a **qualitative improvement has been achieved** in becoming a professional, correct, market-oriented supervision, **which is equally acceptable for all market players**.

The creation of the integrated Supervisory Authority presented a great challenge for the management and staff of HFSA. It called for harmonizing the structures of the differently controlled and managed predecessor organizations which followed substantially different conventions and had different work culture, especially for bringing in line their activities, principles, methods and tools and, in the meantime, ensuring that actual supervisory efforts remain undisturbed, indeed, improving their efficiency. According to international practices managing the period following reorganization is always a critical element of supervisory reorganizations, when a substantial part of the organizations' resources are devoted to defining the new organizations' processes and structure. Based on the events of the recent past we can say that HFSA was clearly successful in managing this period.

In order to efficiently meet the responsibilities of the integrated supervision a **new organization, operating on a new conceptual basis, implementing a more advanced strategy and adapting to the strategic objectives, had to be established**. It was a fundamental requirement for us to have its positive effects already emerge in 2000, so that the supervised institutions, whose number already exceeded one-thousand, would face higher and higher level, increasingly professional, stricter, more consistent, but at the same time market oriented public service Supervisory Authority.

Raising the level of the HFSA's potentials and skills to qualitatively new heights was an essential part of the building process, equally in respect of human resources, applied technologies and technical support for operation.

3.5 Market Orientation

The market stands in the center of the HFSA's activities in several essential respects. It is the fundamental mission of our work to ensure the reliable, transparent and smooth functioning of the money and capital markets. Market concentration is the means for the HFSA to quickly and efficiently follow the developments, **to respond in due time in the best**

manner and with the best tools and to effectively prevent legal violations and their dangerous consequences. We utilize the information that can be gathered in the market in the development of our tools and supervisory behavior. In the meantime we also adapt to the fact that financial groups are becoming dominant in the financial markets today. The integrated supervision has appropriate resources and overview to maintain supervisory and partnership relations with them.

We assign great importance to the dialog with market players in the HFSA's approach in accord with the modern principles of state administration. We intend to rely on the feedback received from the supervised service providers, on market developments and on direct or indirect information about the effects of such developments **in fine-tuning our tools and methods and in getting our measures accepted**. We exploit the dialogue with market players as an important means of providing information and consultation **in the supervisory work aimed at effective enforcement and prevention of the emergence of market factors**, especially in providing advance information. A qualitative advantage of supervision on a consolidated basis is the ability to consult with groups and universal service providers in a manner embracing several branches of the sector. Furthermore, dialogue with members and controllers of groups has the added advantage constituted by the fact that they themselves have a broad perspective and treat the market in an integrated manner, thus they offer remarks with valuable information for us.

During the past two years HFSA put considerable emphasis on establishing more direct contact with the supervised institutions, which was also manifest **in the fact that in 2000 HFSA started to publish recommendations, guidelines** and methodological guidelines, wherein the non-obligatory expectations and good practices related to the supervised institutions are summarized by topics. By today 32 such methodological papers have been published a good part of which deals with risk management and internal audit systems. HFSA emphasized in its supervisory recommendations that the institutions should develop and operate their risk management and internal audit systems focused on the group as well and not merely on individual institutions. HFSA has published a separate methodological guideline on how credit institutions can meet the requirements pertaining to control and risk management in relation to controlling groups stipulated for them by the Credit Institutions' Act. HFSA organizes regular consultation sessions for market players about these methodological papers and other topics that are deemed important from a professional perspective.

3.6 Relationship Manager System

We have developed and introduced a system of relationship managers who follow the same principles in case of all types of supervised institutions. As a result of that the **supervisory work has been renewed, the supervisors' duties and responsibilities have become clear and obvious**. The key advantages of the relationship manager system are:

- **It has become known to all supervised institutions who the contact person at the HFSA is**, who is the staff member in charge, who has all the information on the institution concerned and who could be contacted in case there are questions or problems.
- **A direct connection has been established between the institutions and the HFSA**, which made monitoring the services provided by the supervised organizations and the protection of **the consumers' interest more effective**, furthermore, made it possible **to quickly discover operational disorders** and find the best solution for them.
- The consolidated management of the information available for the HFSA made it possible to determine the set of institutions, where close daily monitoring is warranted, and to separate them from those, where the small market effect and/or the safe operation of institutions allow the employment of simplified methods.
- **The organizational basis of group-level monitoring has been established**; the clear identification of the supervisor responsible for the institutions that belong to the group made it easier to coordinate the activities of supervisors in charge of given groups' supervision and the development of regular supervisory communication.

Consolidated supervision has brought about a qualitative improvement **in our supervisory activities** in several respects. **It made the discovery and management of risks possible in cases when these risks could not be investigated by a supervisory authority focused on a single branch only**. The necessary resources, especially adequately qualified experts, data systems and complex methods, have thus been provided within the framework of consolidated supervision.

3.7 Monitoring and Rating

The development of **efficient monitoring and rating systems** and **their incorporation into investigative technologies** are essential constituents of the practical implementation of our modernized supervisory activities. We have developed the rating system for all the major types of institutions in line with the particularities of the supervised branches and we **do the risk rating of the supervised institutions** relying on those through the regular gathering of information and its standardized evaluation. This rating in turn serves as the basis for determining the optimal method of treatment and for the preventive supervisory efforts. Risk rating considerably helps the HFSA to focus its resources on problem institutions. Today **the HFSA quarterly prepares an internal rating of all institutions that carry systemic risks**. These are partly objective assessments based on various indicators and partly so called subjective qualifications reflecting the quality of corporate management. Internal rating allows for the continuous monitoring of the risks associated with the supervised institutions, thus they provide a solid basis for the on-site inspection that takes place once in every two years in case of most of the supervised institutions, while the conclusions of these investigations supplement and enrich the regular ratings. Thus they enable the staff to have exact information about the institutions they supervise at all times. We **have set up the monitoring and rating system so that it should be capable of supporting consolidated and group level supervisory activities, furthermore, of managing such special and additional risks**.

3.8 Quality Control

The employment of quality control systems has been highly appreciated by international practices spreading quickly. In line with the resulting domestic and international expectations the HFSA's management has also opted for the introduction and employment of an adequate quality control system. Considering the requirements associated with the integration into the European Union we have started to develop a quality control system following the ISO 9001:2000 standard. This is expected **to considerably contribute to narrowing the scope of potential errors, to improving the quality of the supervisory work and the satisfaction of the supervised service providers and consumers seeking our assistance**. The regulation of our processes under the quality control system is of significant help to the HFSA in the market and in **adapting to changes** that occur in the institutional and regulatory environment.

The Government's resolution on the planned tasks for the development of public administration in the period from 2001 to 2002 was published after the decision about the introduction of the quality control system was made. In that the Government called for the adaptation of the General Rating Framework developed in the European Union. We have performed this self-assessment and utilized its results in developing the supervisory activities.

3.9 Analysis

We also employ analyses to support consolidated, preventive and risk-based supervisory efforts. In addition to provide information for external partners and market information for supervisory activities, **analyses also help to make general conclusions supporting the HFSA's work through studying the activities of the supervised service providers, market shifts and what drive those shifts, risk factors and the related trends.** The information simultaneously received by the integrated Supervisory Authority from several financial sectors also make the identification of certain threats and critical points possible, together with the assessment of their potential effects already at the analysis stage. Analyses relying on a consolidated overview are capable of describing the operation of the financial sector broadly embracing the economic environment, thereby making it possible to identify the risks associated with financial mediation, changes and interferences in the national economy, together with the options available for the HFSA to avoid them.

3.10 Developments in Information Technology

In order to establish the IT basis for consolidated supervision HFSA has launched significant development projects, **the most important element of which was the creation of the Complex Information Technology System (CITS).** It is the core function of the CITS's central registration subsystem, its central database, to record the particulars of the supervised institutions licenses and the data they have to report, furthermore, the particulars of other institutions, organizations, or private individuals that comes up in the course of the supervisory work related to the supervised institutions. The fundamental purpose of the subsystem is to reliably and authentically record that information and to make changes traceable, which are essential elements of licensing procedures, the preparation for on-site inspection and of other supervisory activities and measures. Some particulars of institutions and private individuals and the documents supporting such information are obtained by the HFSA in relation to specified events, such as foundation, activity licensing, ownership

change, appointment of offices, securities issue, or acquiring influential participation, etc. Consequently, in order to perform the subsystem's registration function it is essential to manage the information of events, the relevant papers, resolutions and other documents that support the work.

It is part of the CITS data collection subsystem's functions to prepare for, control and process quantifiable reports received from the supervised institutions. The functions of the two subsystems together provide the support necessary for the implementation of consolidated supervision. HFSA is planning the complete introduction of CITS by the end of 2002.

3.11 Preparing Recommendations for Legislative Amendments

The fusion of the former branch specific supervisions has revealed that certain provisions of the specific laws regulating the activities of the supervised institutions are in conflict with each other, or contain unjustifiable differences. These were manifest partly in contradicting rules and partly in regulatory differences that unjustifiably stipulated stricter, or milder rules for one sector, than the other. To remedy this undesirable situation in principle the Government and the legislators had two possibilities: to incorporate every statutory provision pertaining to financial organizations and their supervision into a single comprehensive financial act, or to harmonize the acts covering the individual branches. In both cases one also had to ensure the EU conformity of the resulting legislation, furthermore, that it offered proper legal authorization and an adequate set of tools for equally solid supervisory work throughout the entire financial sector. **One important advantage of the supervisions' integration was precisely the fact that it enabled the emergence of a professional work, which, unifying the professional practices that evolved in the different sectors, took over the best elements in the practice of each sector that could also be applied in other sectors and, in the meantime, made clear recommendations for the statutory modernization required by the accession to the EU. During the past 2 years, upon the initiative of the HFSA, most of the former differences in the laws of the different sectors, the elements often offering possibilities for regulatory arbitrage have been eliminated in the process of harmonizing the laws. When making further amendments to laws special attentions will be paid to ensuring the regulatory consistence between the special laws, e.g. if the same activity is performed by a bank or an investment service provider, independent of the relevant special law, the same rules should apply for this activity.**

4 Legislative Amendments Related to Further Development

It is clear from the above summary that the 2000 fusion of the supervisory organizations offered several practical advantages, which helped the HFSA to be more efficient and united in its actions, thus making significant advances in the setting up the framework of consolidated supervision. However, the unified supervision has still remained limited in exercising consolidated supervision by the fact that group-level statutory provisions on prudential compliance exist only in the Credit Institutions' Act.

In order to let the HFSA make further advances in the area of consolidated supervision certain statutory amendments are inevitable. The elaboration of the provisions contained in the Credit Institutions' Act, the elimination of internal inconsistencies and the supplementation of the capital market and insurance acts with supervisory provisions on a consolidated basis are important not only in order to modernize legislation, but also to achieve legal harmonization with the European Union. There are certain fundamental requirements in the European Union that are not optional for Hungary, but their adaptation is mandatory.

In order to ensure that the statutory amendments meet both fundamental objectives (setting up an efficient set of rules and legal harmonization with the European Union) the HFSA prepared its recommendations concerning consolidated supervision for the amendment of all three acts. This document summarizes the most important principles of the recommendations for legislative amendments, even covering those possibilities, where the EU directives offer a choice for Hungary. **In drafting the recommendations for statutory amendments we have also took the principle into consideration that the new legislation must comply with the EU requirements.** However, every prudential and regulatory constraint is also a tool for the restriction of activities and the ability to generate profits, thus regulation that goes beyond the EU requirements may result in a competitive disadvantage of the institutions registered in Hungary vis-à-vis foreign institutions. The fact, that following the accession to the EU financial organization registered in EU member states are free to open branch offices in Hungary and may directly offer their services, lends a special emphasis to this principle.

In the course of drafting the recommendations for statutory amendments we attempted to make sure that they be completely based on effective EU directives and, simultaneously, be consistent with each other in line with the principle of integrated supervision. However, these two intentions conflicted at times fundamentally due to the

inconsistencies encountered in the EU directives which should be resolved by the Union at European level on the long run.

The regulation of individual groups (controlled by credit institutions, investment firms, or insurance companies) is not unified within the EU. This is a task for the future. However, in preparing the drafts we have tried to define rules that are in accord with each other as much as we could. In this area perhaps the requirements related to consolidated supervision would be defined in a unified manner in a single law in the future.

For the time being there is only a draft directive¹ on the supplementary supervision of financial conglomerates, which nevertheless clearly states that the objective is the supplementation of the former group-level supervisory requirements, while leaving them intact. Harmonization between sectors was scheduled as a future task.

A political consensus has been reached in the EU regarding the draft directive, however, it is not known yet, when it will come into force. Presumably it will take place still in 2002, however, harmonization is to be completed by the member states by 2005. Consequently, in amending and drafting the Hungarian regulation we have to build on the current EU directives and we recommend adapting the provisions that concern financial conglomerates during a future statutory amendment process.

For example, this problem raises fundamental issues, like naming group-level supervision (with respect to the Credit Institution and Capital Market Acts this is referred to as ‘consolidated supervision’, while in the Insurance Act it is referred to as ‘supplementary supervision’), prudential requirements pertaining to the circle of enterprises included in the consolidation, or group-level prudential requirements. Nevertheless, in drafting legislative amendments we attempted to allow discrepancies only where the relevant EU directives reflected the same discrepancies.

All three proposals for legislative amendment are based on the following principles:

- full conformity with the EU must be ensured (this means minor modifications in case of the effective wording of the ACIFE, but necessitates significant amendments in case of the other two acts);

¹ This directive would determine how groups, where insurers are also to be involved in the measurements and not merely deducted as investments, should be treated on a consolidated basis.

- the EU definitions must be taken over, wherever possible literally (however, in some cases it had to be forgone for technical reasons, however, we still tried to ensure compliance in terms of content);
- the scope to be covered by consolidated supervision is to be determined, and the scope within that to which the consolidated prudential requirements are applicable on a group-level as well;
- the prudential requirements (capital requirement calculation, large exposure, or investment limits) and their calculations to be followed by the leader of the group are to be defined;
- the HFSA must be given the competencies enabling it to control and enforce compliance with the provisions stipulated by the act (supervisory competence and the power to impose sanctions);
- the act must cover what is to be inspected by the HFSA in case of enterprises that belong to the group, but do not fall within the requirement of prudential compliance (monitoring transactions within groups).

The detailed summary of the studies on the status of financial groups and the proposals for statutory amendments are included in the annexes.

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Annex No. 1

Activity of the key groups in the financial sector

In accord with international trend mainstream development pointed towards the emergence of groups with a wide scope of activities and substantial financial strength in the Hungarian financial sector as well. The emerging bank or insurer-controlled groups have clearly become the dominant players in all segments of the Hungarian financial market. **The majority of the owners are foreign strategic investors, however, there is also a Hungarian owned group among the banks.** For the purposes of the analysis below we have set up the groups primarily on the basis of ownership relations, though not exclusively on the basis of direct ownership. In cases where there cannot be a proprietary relation (e.g. in case of funds, where the fund's members are the owners) the institution leading the group was dominant through market relations vis-à-vis the other group. The latter was also treated as part of the group for the actual financial scale and influence of the group could be better approximated using this method.

Banking Groups at the End of 2001

In addition to major economic developments in Hungary, the **world economy also has a major influence** on the activities of Hungarian banking groups², their short and long-term objectives and strategic plans, since the Hungarian financial market is increasingly liberalized and the Hungarian financial institutions operate as part of the international arena, integrated into those markets.

The high level of foreign participation, even by international standards, has a decisive influence on the activities of domestic banking groups. At the same time it is to be noted that the parent bank of one of the biggest banking groups does not have a foreign parent bank, its stocks are traded on the exchange and its management is staffed with Hungarian experts. Foreign owners directly own 62.2 percent of the domestic bank sector's registered capital and 60.0 percent of the consolidated registered capital of the 18 banks with banking groups. The

² In this paper by 'banking group' we do not mean the 'banking group' defined in the ACIFE. On the one hand our banking group concept is broader than the scope defined by the ACIFE, since we include all institutions that have an influence on the bank concerned. Thus, we consider the financial organizations owned by the parent, or even the "grandparent" (like NN insurer at the ING Bank, or CA IB at the HVB Bank). On the other hand, we investigate investment funds and funds as well, where banks as asset managers are not owners of the managed assets. At the same time the banking groups monitored by us do not include the institutions that do not provide financial services, although have to be taken into account by the banks when their consolidated balance sheets are prepared.

subsidiaries of foreign owned Hungarian banks are controlled directly or indirectly by multinational institutions that decide about the Hungarian organizations in an international context, thinking in international, European and regional dimensions, making their short-term and strategic plans in accord with the entire international group.

Among the owners of Hungarian banking groups there is a significant number of Western European banks, including German, Austrian, Dutch and Belgian banks. **These Western European parent banks regard** the Central-Eastern European market as offering **important opportunity for expansion**; therefore, they endeavor exploiting market opportunities. The groups organized around foreign parent banks not only compete with each other in Hungary, but in several places around the world. They employ the methods developed to maintain or improve their competitiveness not only in Hungarian institutions, but also in all institutions of the entire financial group. This way the most advanced organizational methods, instruments and infrastructure soon become available in Hungarian institutions.

In 2001 the general economic slowdown and the effects of the September 11 **terrorist attacks** in New York presented the biggest challenge to market players. Recession in itself already leads to tougher **competition**; this gained additional momentum after September 11. **Several Western European banks' profits fell considerably** and because of lending, the securities market and other poorly performing lines of business more than the usual amount had **to be set aside for creating provisions**.

Foreign parent banks of domestic banks were also looking for ways to offset the impacts of the international recession. In order to maintain **competitiveness** efficiency improvements and cost reductions have become inevitable. Many banks **found increasing size the most expedient answer** to achieve these objectives. Foreign parent banks' acquisitions also had an impact on their Hungarian subsidiaries. (The German HVB acquired the Austrian Ba-Ca Bank, while the Dutch AMRO sold the Hungarian ABN AMRO Bank to the Belgian KBC Bank.)

Exploiting the opportunities offered by mergers, utilizing the **synergies, eliminating redundancies, reducing costs and improving efficiency** became the prime responsibilities of the merged banks' new managements. Large foreign parent banks (e.g. German and Austrian) announced their staff reduction plans one after the other, which they solved in part through retirement, part-time employment and natural fluctuation, but they were still forced to lay off thousands of employees. Reorganization aimed at setting the grounds for further growth and

focused on **business lines** that were **more successful, more profitable** and offered better growth opportunities than the rest. The restructuring and lay-offs primarily affected Western Europe and the Far East.

Western European parent banks **did not plan to reduce their activities in the Hungarian market**, quite the contrary, **market development continued**, as the growth of the Hungarian economy, even it slowed down, was still twice as fast as the EU average in 2001. **In 2001 foreign parent banks still viewed the Hungarian market as a financially attractive market with growth potentials**³. Amidst the 2001 mergers of the parent banks the Hungarian subsidiary banks and the institutions that belonged to the banking groups were also merged. In setting up the new integrated banking groups often regional models were employed and staff reductions also took place. Regional development already involved cross-border acquisition activity in case a few banks. However, it is to be noted that remote control and the many regional centers lead to deterioration in efficiency.

The objectives of the parent banks in Hungary are also **competitiveness** and **profitability** that is adequate even by international standards and sustainable even on the long run, furthermore, the **exploitation of growth potentials**. Foreign parent banks laid special emphasis on introducing services in Hungary that were customary at home and which they intended to provide for their clients satisfactorily.

As a result of the parent banks' mergers the number of banking groups decreased. As a consequence of the mergers of KH and ABN AMRO Bank, furthermore, of BA-CA and HypoVereinsbank the number of Hungarian banking groups dropped by 2, thus **at the end of 2001 18 banks has subsidiaries pursuing some sort of financial activities. Of these 10 may be regarded as significant banking groups (OTP, MKB, KH, BB, Postabank, Raiffeisen, CIB, HVB, Erste, ING)**. The dominant banking groups evolved around big banks. There were only two banks, which today belong to the group of big banks, that did not set up a banking group, while two mid-size banks' groups proved to be significant.

From January 1, 1999 licensing universal banking enabled the reorganization of banking groups in Hungary with efficiency and profitability in the prime focus. The merger of investment service provider subsidiaries had begun earlier, but the process speeded up in 2001, when **several parent banks started to integrate their investment service provider**

³ Naturally, in some cases the strategy deviated from the general trend. For example Rabobank and SG Bank reported change of activity and withdrawal from the market.

subsidiaries (IEB, MKB, CIB, Takarékbank, OTP, Hanwha). These developments had not ended yet; not including the investment enterprises being integrated, the number of bank-controlled firms fell from 15 to 9 in a year. (At the end of 2001 altogether 37 investment enterprises operated in Hungary.)

The increasing **willingness of banks and insurers to cooperate** on the basis of mutual advantage became noticeable worldwide. The fusion of the multinational insurance syndicate Allianz and the German Dresdner Bank in July 2001 was a milestone in this process. The owners are hoping to expand the syndicate's selection of products and to exploit synergies resulting from widening the sales channels and increasing the economies of scale. **The fact that banks founded insurance companies indicated a narrowing gap between banking and insurance in Hungary.** In 2001 two banks established their own insurance companies to exploit the potentials in the expansion of the product range. (Volksbank and Erste Bank⁴) **At the end of 2001 of the 26 insurers active in the Hungarian market 7 belonged to banking groups** and 5 had so called 'insurance groups' (at the end of 2000 5 insurers belonged to banking groups).

In 2001 **the number of bank-owned financial enterprises increased** from 34 at the end of 2000 to 41. (At the end of 2001 altogether 187 financial enterprises operated in Hungary.) In 2001 the number of leasing firms that belonged to banking groups grew from 12 to 16, those engaged in mixed activities increased from 9 to 12, furthermore, there were still 3 factoring firms and 5 money lenders in business.

Several banks created voluntary and private pension funds as part of developing their comprehensive services. Thus at the end of 2001 of altogether 120 pension funds (98 voluntary and 22 private) 13 were backed by banks.

Of the 98 investment funds that existed at the end of 2001 asset managers that belonged to banking groups managed 59 funds' assets.

Subsidiaries did not enjoy much independence in the banking groups, parent banks kept them under tight control. In most cases the subsidiaries are only formally independent, in reality their limited power is similar to the parent bank's branch offices. The parent banks finance the subsidiaries. Members of the group normally negotiated deals among themselves under

⁴ In case of Erste Bank the foreign parent bank founded the Hungarian insurer and not the Hungarian subsidiary bank.

market terms; income reallocation took place in a few cases only which are legally allowed. Institutions endeavored to exploit the advantages of the groups using the parent bank's sales channels. Parent banks often assisted the subsidiaries with services in order to reduce costs as well.

Bank group members have different weights in the different segments of the financial sector. **The parent banks** dominate the bank sector, since 8 of the 10 most important banks with banking groups are big banks.

At the end of 2001 the bank-controlled firms managed almost **56.3 percent of the investment firms' total assets**. In 2001 as a result of integrating a few investment firms into their parent banks the weight of the group members decreased.

The 41 bank-owned financial enterprises controlled approximately two-thirds of the financial undertakings' total assets, i.e. firms affiliated with banking groups had an influential role in this market.

With the exception of NN the share of small bank-owned insurance companies was not dominant in the insurance market. Without NN the market share of the bank-owned firms would have been well under one-fourth. Naturally, not the banking, but the insurance groups' influence was significant in the insurance market.

The bulk of the investment funds' assets, almost 96 percent, was managed by asset managers affiliated with banking groups at the end of 2001. In case of the pension funds this ratio was much smaller, merely 44.2 percent. The presence of insurance groups was also obvious in respect of pension funds. At the end of 2001 insurer backed asset managers managed 36.4 percent of the private pension funds' assets and 23.1 percent of the voluntary pension funds' assets.

The weight of banking groups in the financial sector (in percentage)

	Banks		Investment Enterprises		Financial Enterprises		Insurers		Investment Funds		Funds	
	Total assets		Client funds managed ⁵		Total assets		Premium income		Net asset value		Asset value	
	Dec 2000	Dec 2001	Sept 2001	Dec 2001	Dec 2000	Dec 2001	Dec 2000	Dec 2001	Dec 2000	Dec 2001	Dec 2000	Dec 2001
Sector's total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Not affiliated with banking groups	11.9	11.7	40.5	43.7	44.9	32.3	71.6	75.0	4.8	4.5	58.5	55.8
The 10 biggest banking groups	76.2	75.6	44.5	44.7	48.1	62.4	28.4	25.0	94.9	95.0	41.5	44.2
Banking groups' total	88.1	88.3	59.5	56.3	55.1	67.7	28.4	25.0	95.2	95.5	41.5	44.2

The 2001 development of banking group subsidiaries was jointly shaped by the market segment's growth opportunities and the parent banks' plans for the entire banking group. In 2001 the growth of the total assets of the banks controlling the 10 most important banking groups (8 big banks and 2 mid-size banks) was naturally behind the growth of mid-size and small banks, or specialized credit institutions not affiliated with banking groups, either because these were at the early stage of their development, or because they were forced to expand for reasons of economies of scale. The growth rate of big banks that controlled banking groups was almost identical to the growth rate of other parts of the market; therefore, the overall weight of small and mid-size banks did not change.

In case of investment enterprises the consolidated total assets of those affiliated with banking groups decreased less, than the sector's total assets, in spite of fusions into parent banks. The shrinkage of the market fell heavier on the independent firms than on those affiliated with banking groups.

Financial enterprises with bank support could better exploit market growth potentials than those that were not owned by banks; therefore, a substantial difference emerged in terms of the pace of growth between bank-owned and not bank-owned companies.

⁵ The end of 2000 managed client funds figures are not available.

The drop in the premium income of firms affiliated with banking groups in the insurance market was caused by a single big insurer, while other bank-backed companies developed dynamically.

Growth of the financial sector in 2001 (in percentage)

(December 31, 2001 / December 31, 2000)

	Banks	Invest. firms	Financial enterp.	Insurers		Invest. funds	Funds
	Total assets	Total assets	Total assets	Total assets	Premium income	Net asset value	Asset value
Sector's total	112.8	90.5	131.2	120.1	108.1	129.9	141.7
Not affiliated with banking groups	112.4	82.3	94.7	119.1	113.2	120.6	135.2
The ten ⁶ most significant banking group	111.9	96.6	167.4	121.7	95.2	130.1	150.7
Banking groups' total	112.9	92.5	161.1	122.3	95.2	130.4	150.7

Development of the Banking Groups in the First Half of 2002

In the first half of 2002 banking groups continued to play a dominant role in the financial sector compared to the end of 2001. As to the composition of banking groups the previous year's trend continued; banks integrated investment firms into their own organizations in order to improve group-level profitability. Compared to the previous year two of the 18 banking groups, Credigen and Hanwha, disappeared, because their financial undertakings ended their activities. However, this change did not lead to a significant change in the market shares between banking groups. The expansion of the banking groups' activities continued; the foreign expansion of the OTP Group was outstanding (acquisition of a Slovakian bank), several banks (MKB, Erste, CIB and KH) founded financial undertakings, furthermore, an

⁶ Approximately eleven at the end of 2000.

insurer was set up (in the BNP Paribas Group). In the first half of 2002 an institution was also being reorganized as a mortgage bank, without, however, influencing market shares.

Insurance Groups at the End of 2001

We may identify insurance groups as well as banking groups in the domestic financial sector. In case of financial groups branded with the bank's name the bank concerned forms a group by controlling the financial institutions in which it is a majority owner. In case of financial groups branded with an insurer's name the individual financial groups have a slightly different content as the domestic insurance companies are typically in foreign hands. All that means that in making references to insurance groups we do not identify the financial groups on the basis of direct ownership, but rather on the basis of their business relationships. These relationships have special importance both in the long run (with respect to strategy), primarily in relation to pension funds, and on the short run (considering day-to-day operation).

Accordingly we did not associate insurance groups with the domestic insurance companies that have already been considered as members of banking groups (Argosz Biztosító Rt, OTP-Garancia Biztosító Rt., Erste Sparkassen Biztosító Rt., K&H Életbiztosító Rt., ING-NN Magyarországi biztosító Rt., and Victoria Volksbanken Biztosító Rt.). Thus we regarded the financial institutions that could be associated with the following insurance companies as members of insurance groups:

Compared to the end of 2000 in 2001 the 3 investment funds set up by the fund manager that belonged to the Generali Group represented a change among the institutions classified into insurance groups.

2001. Summarizing the above, at the end of December 2001 the following institutions registered by the HFSA and pursuing effective market activities were grouped around these 5 insurance companies:

- 1 out of 4 home savings banks;
- 1 of 37 investment firms;
- 1 of 187 financial undertakings;
- 2 of 21 fund managers.

Insurers are present as owners in the abovementioned home savings bank, investment firm, financial undertaking and fund managers.

One member of the group performs asset management in case of securities funds and pension funds:

- 7 of the 98 open-end securities funds;
- 4 of 22 private pension funds;
- 4 of 98 voluntary pension funds.

We may conclude that as to the scope of activities the ÁB-Aegon Group was the most “versatile”; pension funds played an important role within all insurance groups.

Insurance groups are typically formed with the lead of big **insurance companies**. This was substantiated by the fact that 3 of the insurers looked at were among the 6 companies with the biggest premium income. The 2001 annual premium income of the 6 companies represented a 65.9 percent share from the total premium income. Looking at the year-end portfolio of technical reserves the insurance companies considered in relation to insurance groups represented a 57.2 percent market share in the sector.

As to the market of home savings banks that belong among the specialized credit institutions (4 home savings banks) there was one institution affiliated with the Generali Group that ruled 21.0 percent of the market in terms of total assets.

The investment firm⁷ considered within the Aegon Group had a 5.7 percent market share in third party owned securities portfolio at market prices. This share did not include the securities handed over for asset management by funds. If its place in the sector were determined on the basis of total assets, it would have a 4 percent share. Additionally, it was rather important that in 2001 almost half (44 percent) of the consolidated pre-tax profits of the companies profitable in 2001 were attributable to that investment enterprise.

The **financial undertaking** considered in the AXA Group did not have a market share of analytic significance in respect of total assets. When we looked at the clients’ assets managed by the enterprise it also included the pension funds’ assets handed over for asset management.

As to the **private pension funds**’ assets at market value the 4 private pension funds had a share of 36.7 percent. In case of **voluntary pension funds** this share was somewhat smaller, 23.3 percent. The significant market share of private pension funds that belonged to groups could be explained by the fact that the abovementioned funds were among the first 9 funds of

⁷ Aegon Értékpapír was reorganized from agent to company on January 23, 2002.

the 22 active in the market at the end of the year. With respect to wealth the voluntary pension funds that belonged to groups were among the first 10 out of 98 funds according to year-end figures.

The 4 securities funds managed by a fund manager associated with the Aegon Group and **the 3 securities** funds managed by a fund manager associated with the Generali Group accounted for 2.0 percent of the **total gross asset value** of the 98 securities funds at the end of 2001.

Overall, we may conclude that **the equity capital of the 5 insurance companies regarded as groups was almost 100 percent in foreign hands**. The investment firm associated with the Aegon Group is almost 100 percent owned by the insurer, however, not the Hungarian, but the foreign insurer has an interest in the financial enterprise associated with the AXA Group. The asset managers of pension funds (both private and voluntary funds) were mostly group members. **It can be said of all insurance groups that besides insurance pension fund activities have a dominant role.**

Independent Insurance Groups' Weight in the Financial Sector (in percentage)

(percentage)

Typical data	Insurance company		Home savings bank		Investment firm		Financial undertaking		Investment fund		Private pension fund		Voluntary pension fund	
	Technical reserves (bHUF)		Total assets (bHUF)		(Managed securities)		Total assets (bHUF)		Gross asset value (bHUF)		Assets (book value)		Assets (book value)	
	Dec 2000	Dec 2001	Dec 2000	Dec 2001	Dec 2000	Dec 2001	Dec 2000	Dec 2001	Dec 2000	Dec 2001	Dec 2000	Dec 2001	Dec 2000	Dec 2001
Members of insurance groups	59	57.2	22.5	21	n/a	5.7	0.1	0.1	1.0*	2	36.2	36.7	22.7	23.1
Members of banking groups	34.8	35.7	46.2	47.4	n/a	56.3	55.2	67.6	94.8	95.6	51.4	52.8	34.6	35.7
Not members of financial groups	6.2	7.1	31.3	31.6	n/a	38	44.7	32.3	4.2	2.4	12.4	10.5	42.7	41.2
Sectors total	100	100	100	100	-	100	100	100	100	100	100	100	100	100

*Only the gross asset value of the securities fund managed by a fund manager of the Aegon Group is shown.

Development of the Insurance Groups in the First Half of 2002

During the first half of 2002 no significant changes occurred in the groups' market share, although compared to the end of 2001 Credit Suisse Life (through Winterthur Leben AG) acquired influential participation in the Hungarian Winterthur Biztosító. In connection to that, on the one hand, the Group was enlarged with Credit Suisse Asset Management Hungary Alapkezelő (fund manager) and the investment funds it controlled, on the other hand, the name of each group member changed. 2002. In the first half of the year an agreement was reached between the parties, however, the portfolio transfer of OTTHON Magyar-Osztrák Lakástakarékpénztár to Lakáskassza-Wüstenrot Lakástakarékpénztár, which will have an influence on the composition of the Generali Group, will only commence from September 1, 2002.

The composition of banking groups and insurance groups at the end of 2001 and the changes during the first six months of 2002 are shown in the table below.

Banking group members			
		End of 2001	Changes in the first 6 months of 2002
1	Banking group	OTP	
	Parent bank	OTP Bank Rt.	
	Home savings bank	OTP Lakástakarékpénztár Rt.	
	Subsidiary bank	Merkantil Bank Rt.	OTP Jelzálogbank Rt. Jan 10, 2002, new license
	Foreign institution		IRB Slovakian bank Acquisition
	Investment firm	OTP Értékpapír Rt.	Institution closed at own request Until Aug 31, 2002
	Financial undertaking	OTP Faktoring Követeléskezelő Rt.	Merkantil Ingatlan Lízing Rt. Jan 28, 2002, new license
		Wallízing 2000 Pénzügyi Szolgáltató Rt.	
		Merkantil-Car Gépjármű Lízing Rt.	
	Insurer	OTP-Garancia Insurer Rt.	
	Investment fund	OTP Optima	OTP Dollár, OTP Euró
		OTP Paletta Nyíltvégű Bef. Alap	
		OTP Platina Nemzetközi Részvény	
		OTP Quality Részvény	
		OTP Maxima Kötvény	
	Private fund	OTP Magánnyugdíjpénztár	OTP Egészségpénztár Jan 23, 2002 founding general meeting
	Voluntary fund	OTP Önkéntes Kiegészítő Nyugdíjpénztár	
		OTP Quantum Kiegészítő Nyugdíjpénztár	
2	Banking group	MKB	
	Parent bank	MKB Rt.	
	Investment firm	MKB Értékpapír Rt.	Closed, Jan 2002 activity license revoked
	Financial undertaking	MKB Lízing és Pénzügyi Rt.	Filease Lízing Acquisition

	undertaking		Szolgáltató Rt.	
		MKB Eurocredit Kereskedelmi és Szolgáltató Rt.		
		MKB Euroleasing Rt.		
		EXTER-IMMO Rt.		
	Investment fund	MKB II Nyíltvégű részvényalap		
		MKB Nyíltvégű Állampapír		
		MKB Nemzetközi Kötvény		
		MKB Európai Részvény		
	Private fund	MKB Nyugdíjpénztár Magán ág		
	Voluntary fund	MKB Nyugdíjpénztár Önkéntes ág		
3	Banking group	KH		
	Parent bank	Kereskedelmi és Hitelbank Rt.		
	Investment firm	K&H Equities (Hungary) Értékpapírkereskedelmi Rt.		
		K&H Vagyonkezelő Rt.		
	Financial undertaking	K&H Lízing Rt.	KH Pénzügyi Szolgáltató Rt.	Dec 17, 2001, new license
		Kvantum Követeléskezelő és Befektetési Rt.		
		K&H Eszközfinanszírozó Pénzügyi Lízing Rt.		
		Magyar Factor Pénzügyi Szolgáltató Rt.		
		Pannonlízing Pénzügyi Szolgáltató Holding Rt.		
		K&H Autófinanszírozó Pénzügyi Szolgáltató Rt.		
	Insurer	K&H ÉletInsurer Rt.		
		ARGOSZ Insurer Rt.		
	Investment fund	K&H bond		
		K&H stock		
		K&H money market		
		KH Aranykosár		
		KH Navigátor		
		KH Unió és Amerika		

	Private fund	Aranykor K&H Bank Országos Önkéntes és Magánnyugdíjpénztári ág		
	Voluntary fund	Aranykor K&H Bank Országos Önkéntes és Magánnyugdíjpénztári ág		
4	Banking group	BB		
	Parent bank	Budapest Hitel- és Feljesztési Bank Rt.		
	Investment firm	BÉB	Merged into the bank	Feb 27, 2002, activity license revoked
	Financial undertaking	BB Ingatlan Rt.	Merged into the bank	April 25, 2002, cancellation
		Budapest Áruhitel Rt.	Merged into the bank	April 25, 2002, cancellation
		Budapest Autófinanszírozási Rt.		
		Budapest Lízing Rt.		
	Investment fund	Budapest Bonitas		
		Budapest I. Befektetési Alap		
		Budapest II. Befektetési Alap		
		Budapest Nemzetközi Kötvény		
		Budapest Nemzetközi Részvény		
		Budapest Növekedési Alap		
		Budapest Számlafedezeti		
		Civis 95 Befektetési Alap (new name: mixed...)		
	Private fund	Budapest Magánnyugdíjpénztár		
	Voluntary fund	Budapest Önkéntes Nyugdíjpénztár		
5	Banking group	Postabank		
	Parent bank	Postabank és Takarékpénztár Rt.		
	Subsidiary bank	Polgári Kereskedelmi Bank Rt.	Being transformed into mortgage bank	
	Investment firm	Postabank Értékpapírforgalmazási és Befektetési Rt.		
	Financial undertaking	Postabank-Leasing Pénzügyi Szolgáltató Rt.		

	Investment fund	Postabank Hozamgarancia		
		Postabank Lokomitív Részvény		
		Postabank Családfa		
		Postabank Millenium		
6	Banking group	Raiffeisen		
	Parent bank	Raiffeisen Bank Rt.		
	Investment firm	Raiffeisen Értékpapír és Befektetési Rt.		
	Financial undertaking	RAIFFEISEN Lízing Rt.		
		RAIFFEISEN PROPERTY Lízing Rt.		
	Investment fund	Raiffeisen kötvényalap		
		Raiffeisen részvényalap		
		Raiffeisen pénzügyi alap		
		Raiffeisen nemzetközi kötvény		
		Raiffeisen nemzetközi részvény		
		Raiffeisen likviditási		
7	Banking group	CIB		
	Parent bank	CIB Közép-Európai Nemzetközi Bank Rt.		
	Investment firm	CIB Értékpapír Rt.		
	Financial undertaking	CIB Ingatlanleasing Rt.	CIB Credit Rt.	Nov 27, 2001, new license
		CIB Leasing Rt.		
		CIB Credit Rt.		
	Investment fund	CIB Kincsem nyíltvégű		
		CIB Nemzetközi Értékpapír		
		CIB Részvény		
		CIB Pénzügyi		
	Voluntary fund	CIB Önkéntes Kölcsönös Nyugdíjpénztár		
8	Banking group	HVB		
	Parent bank	HVB Bank Hungary Rt.		
	Investment firm	CAIB Értékpapír Rt.		
	Financial	Arany Pénzügyi Lízing Rt.		

	undertaking			
		BA-CA Ingatlanlizing Szolgáltató Rt.		
		Bank Austria Creditanstalt Leasing Hungary Rt.		
		Bayern-Leasing Hungária Rt.		
	Investment fund	CA Devizarészvény Alap		
		CA Kötvény Alap		
		CA Közép-Eu-i Részvény (previously: CA Növekedési Alap)		
		CA Pénzpiaci Alap		
		CA Részvény Alap		
		CA Selecta		
		CA V.		
		CA Közép-Eu-i Kötvény		
		CA Közép-Eu-i Részvény		
		CA TopPharma		
	Private fund	BA-CA –Életerő Magánnyugdíjpénztár		
	Voluntary fund	CA -Diófa Borostyánkő Nyugdíjpénztár		
9	Banking group	Erste		
	Parent bank	Erste Bank Hungary Rt.		
	Investment firm	Erste Bank Befektetési Magyarország Rt.		
	Financial undertaking	Immorent Hungary Lízing Rt.	Erste S Leasing Pénzügyi Szolgáltató Rt.	Dec 17, 2001, new license
	Insurer	Erste Sparkassen Biztosító Rt.		
	Investment fund	ALPOK Állampapír		
		ALPOK Tradíció		
		ALPOK Részvény és Nk Rv		
	Private fund	Erste Bank Országos Nyugdíjpénztár		
	Voluntary fund	Erste Bank Önkéntes Nyugdíjpénztár		
10	Banking group	ING		
	Parent bank	ING Bank Magyarország Rt.		

	Investment firm	ING Barings	Merged into the bank	
		ING Investment Management Magyarország Vagyonkezelő Rt.		
	Insurer	ING NN Magyarország Biztosító Rt.		
	Investment fund	ING Globális Részvény		
	Private fund	ING NN Magánnyugdíjpénztár		
	Voluntary fund	ING NN Önkéntes Nyugdíjpénztár		
11	Banking group	Takarékbank		
	Parent bank	Magyar Takarékszövetkezeti Bank Rt.		
	Investment firm	Takarék Bróker	Closed	May 30, 2002 activity licence revoked
	Investment fund	Takarék III. részvény		
		Takarék Állampapír		
		Takarék pénzügyi		
12	Banking group	Citi		
	Parent bank	Citibank Rt.		
	Financial undertaking	CitiBusiness-Leasing Rt.-vé alakult tavaly a bróker		
13	Banking group	Hanwha	Banking group closed	
	Parent bank	Hanwha Bank Magyarország Rt.		
	Investment firm	Hanwha Capital Budapest Rt.	Merged into the bank	Resolution mailed on April 19, 2002
14	Banking group	IE		
	Parent bank	Inter-Európa Bank Rt.		
	Investment firm	IE NewYork	Closed	Feb 26, 2002 activity licence revoked
15	Banking group	MFB		
	Parent bank	Magyar Fejlesztési Bank Rt.		
	Subsidiary bank	Konzumbank Kereskedelmi Bank Rt.		
	Financial undertaking	Magyar Követeléskezelő Rt.		
		BÁV-Zálog Pénzügyi Szolgáltató Rt.	Sold	

16	Banking group	Credigen	Banking group closed	
	Parent bank	Credigen Bank Rt.		
	Financial undertaking	Hipermarket Rt.	Closed	Cancellation March 27, 2002
17	Banking group	BNP Paribas		
	Parent bank	BNP Paribas Hungária Bank Rt.		
	Financial undertaking	NBC Pénzügyi Szolgáltató Rt.		
		BNP Paribas Lease Group Lízing Rt.		
	Insurer		Cardif licensing in progress	
18	Banking group	Volks		
	Parent bank	Magyarországi Volksbank Rt.		
	Financial undertaking	VB Pénzügyi Leasing Rt. (volt: Mo. Volksbank Pü. Lízing Rt.)		
	Insurer	Victoria Volksbanken Életbiztosító Rt.		
		Victoria Volksbanken Biztosító Rt.		

Insurance group members				
		End of 2001	Changes in the first 6 months of 2002	
1	Insurance group	ÁB-Aegon csoport		
	Parent insurer	ÁB-Aegon Általános Biztosító Rt.		
	Home savings bank			
	Investment firm	Aegon Értékpapír Rt.		
	Financial undertaking			
	Investment fund	Aegon belföldi kötvény		
		Aegon belföldi részvény		
		Aegon nemzetközi kötvény		
		Aegon nemzetközi részvény		
	Private fund	ÁB-Aegon Nyugdíjpénztár Magán pénztári ágazat		

	Voluntary fund	ÁB-Aegon Nyugdíjpénztár Önkéntes pénztári ágazat		
2	Insurance group	Allianz Hungária csoport		
	Parent insurer	Allianz Hungária Biztosító Rt.		
	Home savings bank			
	Investment firm			
	Financial undertaking			
	Investment fund			
	Private fund	Allianz Hungária Biztosító Rt. Nyugdíjpénztára Magán pénztári ág		
	Voluntary fund	Allianz Hungária Biztosító Rt. Nyugdíjpénztára Önkéntes pénztári ág		
3	Insurance group	AXA csoport		
	Parent insurer	AXA Biztosító Rt.		
	Home savings bank			
	Investment firm			
	Financial undertaking	Axa Vagyonkezelő Rt.		
	Investment fund			
	Private fund	Axa Colonia és Heller Farkas Első Magyar Közszolgálati Nyugdíjpénztár (Magán)		
	Voluntary fund	Axa Egyesült Közszolgálati Nyugdíjpénztár (Önkéntes)		
4	Insurance group	Winterthur csoport	Credit Suisse csoport	
	Parent insurer	Winterthur Biztosító Rt.	Credit Suisse Life & Pensions Biztosító Rt.	The Swiss Credit Suisse Life increased its participation in the Hungarian Wintertur Biztosító Rt. to 65 percent through Winterthur Leben AG
	Home savings bank			
	Investment firm			
	Financial			

	undertaking			
	Investment fund		Credit Suisse Magyar Kötvény Alap	Investment funds managed by Credit Suisse Asset Management Hungary Alapkezelő Rt.
			Axa Európai Részvényalap	
			Arany Oroszlán	
			Credit Suisse Globális Részvény Alap	
	Private fund	Winterthur Nyugdíjpénztár Magán pénztári ág	Credit Suisse Life & Pensions Nyugdíjpénztár Magán pénztári ág	Name change
	Voluntary fund	Winterthur Nyugdíjpénztár Önkéntes pénztári ág	Credit Suisse Life & Pensions Nyugdíjpénztár Önkéntes pénztári ág	Name change
5	Insurance group	Generali csoport		
	Parent insurer	Generali-Providencia Biztosító Rt.		
	Insurance company	Európai Utazási Biztosító Rt.		
	Home savings bank	Lakáskassza-Wüstenrot Lakástakarékpénztár Rt.		As of Sept 1, 2002 the portfolio transfer of OTTHON Magyar-Osztrák Home Savings Bank Rt. to Lakáskassza-Wüstenrot Home Savings Bank Rt was completed
	Investment firm			
	Financial undertaking			
	Investment fund	Generali Első Nyugdíjpénztári		
		Generali Gold		
		Generali Cash		
	Private funds			
	Voluntary funds			

Annex No 2.

The Proposals Made by the Hungarian Financial Supervisory Authority for Statutory Amendments in the Interest of Developing Supervision on a Consolidated Basis

1 Proposal for the Amendment of the Act on Credit Institution and Financial Enterprises (hereafter: ACIFE)

1.1 General Summary

The fundamental rules pertaining to the supervision of credit institutions on a consolidated basis are laid down in Directive 2000/12/EC relating to the taking up and pursuit of the business of credit institutions. The current ACIFE has already partly adapted the EU principles on consolidated supervision, but often, especially in the definitions, the scope of consolidation and prudential requirements further clarifications are needed.

In elaborating the proposals **one of the gravest problem was encountered in matching the concepts, especially the concepts of ‘financial institution’ and ‘financial services’**. The EU Directive defines ‘financial institution’⁸ as an undertaking other than a credit institution, or a financial holding company the principal activity of which is to provide financial services as defined in the EU. However, domestic regulation has divided the list of financial services provided in the EU Directive into two parts, one of which has been dealt with in the ACIFE, while the other has been moved as investment service under the Capital Market Act (to be more precise, under its predecessor, the Securities Act). Consequently, if we wanted to fully adapt the EU concept of ‘financial institution’, it would have to be defined as any undertaking other than a financial holding company, or credit institution that engages in at least one of the financial service, or ancillary financial service activities defined in Section 3 of the ACIFE, or one of the activities provided under Sections 81 and 229 of the Capital Market Act. That way the present investment firms would also be embraced by the concept of ‘financial institution’ and would constitute a sub-category of that.

However, after thorough consultations and careful thinking the HFSA’s management has decided not to include the complete adaptation of the concepts of ‘financial institution’ and ‘financial service’ in the current proposal. At present the ACIFE and several other statutes

⁸ In contrast to the concept of ‘financial institution’ defined in the ACIFE, which embraces credit institutions and financial undertakings.

employ these concepts, as a result of which several statutes would have to be substantially reworded. This enormous work would substantially slow down the current legislative amendments and would threaten the possibility of other, also very important modifications coming into force from the beginning of the next year. Therefore, we have prepared the proposals for amendment using the current Hungarian concepts, while they fully meet the requirements of the EU Directive in terms of content. Nevertheless, accompanying the draft amendments we indicated the problem to the Ministry of Finance, noting that it must be solved by January 1, 2004 the latest.

In the proposals submitted with respect to the ACIFE our starting ground, similarly to the EU, has been that there are three important types of groups that the Act must cover. **The first type includes the groups controlled by credit institutions**, where the Act would require leading credit institutions to comply with the limitations pertaining to capital adequacy and risk exposure (including the investment limits) on a consolidated basis (including ancillary banking services undertakings) as well, if they have a subsidiary that is an other credit institution, financial undertaking, or investment firm, or have participation in any such institution. The bill would not compel the leading credit institution to include other types of undertakings within the consolidated prudential limits, but it would secure the HFSA's right to compel any credit institution to include an undertaking. In the event the HFSA did not impose such an obligation, it would still be entitled to request information from any of the credit institutions' related enterprises, or to conduct on-site inspection in order to establish what risk a given undertaking may present to the credit institution's prudential operation.

The second important type includes the group lead by a financial holding company. In that case the financial holding company shall be obliged to calculate the capital adequacy and risk exposure limits covering related credit institutions, financial undertakings, investment firms and ancillary banking services undertakings. The financial holding company forwards the calculated figures to the credit institution, which, in turn, submits them to the HFSA.

The third important type includes the group led a mixed-activity holding company. Pursuant to the ownership constraints in the ACIFE (a share exceeding 15 percent may only be acquired by the Hungarian State, other credit institutions, the universal postal service provider, insurance institutions, investment companies, financial holding companies and the National Deposit Insurance Fund) the circle of undertakings that the consolidated supervision may extend to is restricted. As for credit institutions and financial holding companies the

ACIFE itself contains provisions (refer to the previous paragraphs), the groups controlled by investment companies will have to be supervised on a consolidated basis according to the Capital Market Act⁹, thus the concept of ‘mixed-activity holding’ would practically include the universal postal service provider and insurance institutions.

The bill would have milder provisions pertaining to mixed-activity holding company in line with the EU Directive, than for the types of groups mentioned in the first two categories and the HFSA’s responsibilities would primarily consist of gathering information in the form of requesting data, or conducting on-site inspection. In case of this type of group the HFSA would assess the degree to which the risks associated with the rest of the members of the group threaten the prudential operation of the credit institution belonging to the group controlled by a mixed-activity holding company.

It is important to note that the bill clearly states that the HFSA is not responsible for the prudential supervision of the financial holding company and the mixed-activity holding company on an individual basis (naturally, if those were institutions to be supervised pursuant to another act, such as an insurance company, then supervision would have to be provided on the basis of rules set forth therein).

1.2 Detailed Summary

Our recommendations concerning the ACIFE are summarized in detail below.

In drafting the bill we considered the elements that **must be** complied with by all member states of the EU. These have been taken over without change and concern the following topics:

1 Definitions

In order to give a precise definition for what is covered by consolidated supervision, and to determine the scope of undertakings that are to be included in calculations on a consolidated basis the concepts of ‘**parent company**’, ‘**subsidiary**’, ‘**control relationship**’ and ‘**participation relationship**’ have been pinned down in conformity with EU concepts.

⁹ This is necessary because the Capital Market Act will have much stricter provisions for groups lead by investment firms, than the ACIFE for groups controlled by mixed activity holding companies.

2 The scope of institutions falling under supervision on the basis of consolidated financial situation includes: every credit institution

a that have at least one credit institution, financial undertaking, or investment firm subsidiary, or has a participation (capital or voting rights of 20 percent or more) in any such institution;

b whose parent company is a financial holding company.

It is to be noted that one of the critical points of the debates conducted at the HFSA last year was whether the scope of institutions to be consolidated under accounting rules and under prudential supervision corresponded to each other. Based on talks with foreign experts we may conclude that these two differ in other countries as well, indeed, occasionally the method for the inclusion of individual subsidiaries in the consolidation may also vary. For that reason in our recommendation we have dealt with the scope of institutions to be drawn into consolidated supervision clearly separated from the scope of accounting consolidation.

3 Consolidated calculation cover the groups defined above. The credit institution parent companies in section a) above and the financial holding companies in section b) above are obliged to do consolidated calculations. This, however, shall not mean that the HFSA should monitor financial holding companies on an individual basis, its responsibilities are limited to those defined in other parts of the ACIFE.

4 The scope of undertakings **to be included in consolidated calculations** are: credit institutions, financial undertakings, investment firms and ancillary undertakings that are subsidiaries of institutions included in consolidated supervision, or in which such institutions have a participation of 20 percent or more.

Therefore, in case of credit institution groups insurers do not have to be included in the consolidated calculations, rather they should be treated as investments during the calculation of the regulatory capital.

5 What is included **in consolidated calculations**:

- capital adequacy ratio;
- the regulatory capital required to cover the trading book position risks, counterparty risks, large exposures, furthermore, the commodity risks

- the regulatory capital required to cover foreign exchange risks;
- compliance with large exposure and investment limits.

6 The applicable methods for involving credit institutions, financial undertakings and ancillary undertakings in the above calculations:

- **subsidiaries** are to be fully consolidated, according to the rules of the Accounting Act;
- if a participation exceeding 20 percent qualifies **as joint control**¹⁰ and it is guaranteed that the amount of commitments does not exceed the ownership share, then **in proportion to the capital participation**, according to the rules of the Accounting Act;
- other participations exceeding 20 percent do not have to be included in the consolidated calculations, rather they have to be evaluated as investments according to the so-called equity method.

As the calculation of the regulatory capital on a consolidated basis is practically identical to the calculation of the regulatory capital on an individual basis (apart from the necessary adjustments), the participations that qualify as qualifying holdings in other financial sector (credit institution, financial undertaking, investment firm, investment fund manager and insurer) investments and investments in the financial sector exceeding 10 percent of the parent company's regulatory capital shall be deducted. Thus the deduction affects the range of institutions, where the investment is between 10 percent and the 20 percent qualifying for joint control boundary. In excess to that the undertaking to be involved shall appear in the consolidated balance sheet and (consequently) in the consolidated regulatory capital.

4 The determination of the member states carrying out consolidated supervision and the cooperation between them. The approach compliant with the EU Directive has been taken over in the bill.

¹⁰ According to the Accounting Act a business association is jointly controlled, if, on the one hand, the parent company (the parent company's subsidiary included in the consolidation) and, on the other hand, the other undertaking(s) have at least 33 percent of the voting rights. A jointly controlled undertaking is jointly managed by the co owners.

- 5 **The introduction of the concept ‘close link’ and its incorporation among licensing requirements.** ‘Close link’ according to the EU Directive: shall mean a relationship between two or more natural or legal persons based on control or participation. The HFSA licenses the credit institution to be included in consolidated supervision on that basis.

1.3 **Discretionary options**

However the Directive 2000/12/EC leaves several issues **to the discretion** of each member state. These and the solutions we are proposing are the following:

- 1 The default is that each credit institution, which has a subsidiary credit institution, financial undertaking, investment firm, or investment fund manager, or has a participation in any such institution, has to do the consolidated calculations. However, the member states may waive **subconsolidation**, if the distribution of regulatory capital is appropriate within the group. The bill takes over this option and authorizes the HFSA to waive subconsolidation.
- 2 We also intend stick to **requiring compliance** with provisions on banking operations **on an individual basis** from institutions that also report on a consolidated basis (the EU Directive allows the HFSA to waive institutions from individual compliance with prudential requirements, in the event they belong to one and the same group and the group as a whole complies with prudential requirements). As this possibility is not included in the proposal, consolidated monitoring will appear as a supplementary element for supervision on an individual basis. This is in accord with the provisions currently in force and with the practices followed by most European countries.
- 3 The supervisory authority has a discretionary option with respect to **the circle of undertakings to be included in the consolidated calculations**. The option to be exempted from inclusion in consolidated calculations has been taken over, similarly to the effective ACIFE (information is not available, the inclusion of the undertaking is misleading or insignificant with respect to the purpose of consolidated supervision). For the sake of further EU harmonization a clarification has been made as regards to when an undertaking could be regarded as insignificant with respect to consolidated supervision.

4 It is also up to the discretion of the member states **to allow the inclusion of any subsidiary** that qualifies as a credit institution, financial undertaking, investment firm, investment fund manager, or ancillary undertaking **proportionately, rather than fully according to the main rule** in consolidated calculations. It presupposes that the liability of the parent company is limited to its share of the capital equity participation and the co-owners' solvency is satisfactory.

Since the undertakings to be included are supervised institutions there is nothing against the inclusion of this exemption in the act, thus it has been made part of the proposal.

5 Inclusion of **investment fund managers** in consolidated supervision is not a requirement on the basis of EU directives, but according to consultations with German experts under certain circumstances their inclusion in consolidated supervision may nevertheless be warranted. The reason for that is that there are certain guarantees (like yield guaranteed by investment fund managers) that appear as off-balance sheet items in fund managers accounting reports and may influence the groups' operation.

Thus there are two options for investment fund managers as a matter of choice.

a) By default investment fund managers do not fall under consolidated supervision and though they do not have to be involved in calculations on a consolidated basis, however the law entitles the HFSA to deem any investment firm as one that is to be included on the basis of individual considerations.

b) As a rule investment fund managers are to be included in consolidated supervision, but the statutes would open to door for the HFSA to grant exemptions.

The two versions produce the same end results. However, the second has the advantage that the HFSA does not have to oblige a supervised institution to do anything, rather it may waive an obligation. Yet, we have included the first version in the proposal because in our view generally investment fund managers are not to be included, compared to which it is the exception when the HFSA orders the credit institution to be included.

The inclusion of **funds** could be justified on account of the reputation risk of the parent company, but we do not consider that similarly to the practice followed in other countries.

- 6 We did not include the clause in the bill, which would allow for credit institutions that must also meet the capital adequacy requirements on a consolidated basis not to deduct their qualifying holdings in other credit institutions, financial undertakings, or investment service providers, or their investments in other financial service providers that do not qualify as qualifying holdings, but exceed 10 percent of their regulatory capital during the calculation of the regulatory capital on individual basis.
- 7 Based on the draft Eximbank and the Magyar Fejlesztési Bank (Hungarian Development Bank) would not be obliged to calculate their compliance with prudential requirements on a consolidated basis as well¹¹, nevertheless, subconsolidation would still be required.
- 8 According to the EU Directive the bigger of two institutions that qualify as sister companies can apply for being included in consolidated supervision and to satisfy the prudential requirements on a consolidated basis as well from that point on. The potential explanation for that is that the credit institution is exempted from the large exposure limit in relation to the sister institution. This option is included in the proposal.

1.4 Keeping the current requirements

In spite of the changes in drafting the amendments of the ACIFE **parts that have already met the EU requirements** and elements that make the practical implementation of consolidated supervisory regulation easier **remained** (or were subjected to minor clarifications only) unchanged. These are the following:

- 1 Rules pertaining to supervisory registration;
- 2 Rules pertaining to control on a consolidated basis (such as the managing director's responsibilities);
- 3 Reporting requirements;

¹¹ It can frequently be seen in the practices of other EU countries as well that such kind of institutions are treated in a way that is different from the standard rules for credit institutions.

- 4 Supervisory control rules;
- 5 Meeting the real estate investment constraints on a consolidated basis is not required by EU directives. As there is nothing in against the imposition of stricter rules, compliance with that is not in conflict with legal harmonization.

1.5 Minor discrepancies from the EU Directive

On two occasions we have defined rules **in support of easier interpretation and supervisory application**.

- 1 The first of these concerns the determination of **the circle of institutions, from which the HFSA may request data and information**, if the supervision of institutions included in consolidated supervision justify that. This does not merely affect downward relationships, but upward and horizontal (i.e. sister companies) relations as well.

The determination of that circle is based on Directive 98/78/EC on the supplementary supervision of insurance undertakings in an insurance group.

- 2 Another issue related to consolidated supervision that has not been included in the legislation before and not required by EU directives either concerns the HFSA's scope of **admissible measures**.

As to actions taken it is a new element compared to the supervisory practice on individual basis is that the HFSA may take an action, or extraordinary measures even, if credit institutions

- a fail to satisfy the prudential requirements on a consolidated basis;
- b do not meet their consolidated reporting obligation;
- c do not have the accounting, management information, risk management and control systems needed for consolidated supervision.

The most important measures are: the possibility of issuing a supervisory resolution on the alienation of investments and on restricting transactions within the group.

2 Capital Market Act

The provisions pertaining to the supervision of investment firms on a consolidated basis are laid down in Directive 6/93/EC on the capital adequacy of investments firms and credit institutions (CAD). For the most part the Directive refers back to the provisions pertaining to the supervision of credit institutions on a consolidated basis and contains only a few particularities that require different treatment in case of investment firms. Therefore, the proposals for the amendment of the Capital Market Act drafted by us are essentially identical to the proposals made for the ACIFE, apart from a few minor discrepancies, such as the definition of ‘financial holding company’ (under the Capital Market Act financial holding companies as defined by the ACIFE do not qualify as such unless they have an investment firm subsidiary).

The sole essential difference between the two types of undertakings in consolidated supervision is not expressly tied to consolidated supervision, but is related to that. Directive 93/6/EEC offers an alternative definition for the investment firms’ regulatory capital, which is stricter than either the effective or the future credit institution regulation, as according to that all illiquid assets are to be deducted. The problematic item in the calculation is the trading book net profit figure for the calculation of the regulatory capital, because it is not resolved in accounting. At the same time it must be emphasized that the alternative regulatory capital calculation is only an option in the EU Directive as well, so by not taking it over into the Hungarian regulation, we have nevertheless complied with the EU Directive. The adoption of the rule is, therefore, not so much a legal harmonization issue, rather a prudential one.

The EU Directive permits investment firms relying on the alternative calculation of the regulatory capital to include supplementary subordinated loan capital used to cover market risks, which is normally determined at 200 percent of the original own funds, at a higher rate, up to 250 percent of the original own funds. This is an interesting provision because this ratio may be 250 percent in case of credit institutions with permission from the supervisory authority without any the imposition of further condition. Thus here the EU slightly deviates from the general principle of equal treatment for identical activities. We have resolved this problem in the Hungarian proposal by recommending the ceiling for the inclusion of supplementary subordinated loan capital at 200 percent of the original own funds both for credit institutions and investment firms, thus meeting both the EU requirements and complying with the requirements of regulating of competition on equal terms.

The HFSA's position was unambiguous in that not yet realized trading book profits must not be acknowledged as part of the regulatory capital under the effective regulation and the current market conditions. As this greatly reduces interest in calculating the regulatory capital according to the alternative definition, we have not even mentioned this option among the proposed amendments of the Capital Market Act. At the same time the EU Directive also prescribes that in groups controlled by investment firms another investment firm may only be exempted from inclusion in the calculation of consolidated limits, if both firms calculate their regulatory capital the stricter rules. The tightening is manifest partly in that investments in financial institutions, investment firms and insurers are not to be deducted from the amount of the overall regulatory capital requirement, but from the core capital (which tightens the possibility of including subordinated capital) and partly in that illiquid assets (such as real estates, overdue loans and long-term investments) are to be deducted from the regulatory capital. Since the Capital Market Act, similarly to the ACIFE, permits exemptions, in our proposal the range of exemptions must include that in case of investment firms the HFSA can make the exemption depend upon the conditions provided in the Decree of the Minister of Finance. The detailed conditions of exemption and the methods needed for the stricter regulatory capital calculation would thus be part of the Decree of the Minister of Finance.

It is important to note with respect provisions of the Capital Market Act pertaining to groups controlled by investment firms, that such groups do not exist at present, but several investment firms do have investment fund manager subsidiaries, whose inclusion in consolidation may be requested by the HFSA, if necessary.

3 Insurance Act

Directive 98/78/EC on the supplementary supervision of insurance undertakings in an insurance group and the adjusted solvency calculation has been taken as the basis for the proposals to amend the Insurance Act. As it can be seen on the title already the EU employs a different definition in case of insurers and gives a definition for 'supplementary supervision' rather than 'consolidated supervision'. Part of the discrepancy is due to the fact that different working groups have drafted the different directives, however, there is a significant difference also in terms of substance between the two definitions.

The proposal based on the EU Directive may briefly be summarized as follows: All insurers

A having a participation in at least one other insurer, reinsurer or third country insurer;

- B whose subsidiary is an insurance holding company, reinsurer or third country insurer;
 - C whose parent company is a mixed-activity insurance holding company
- shall be subject to supplementary supervision.

Supplementary supervision shall extend to all

- A undertakings with participation in the insurer (participating undertaking);
- B undertakings that qualify the insurers' related undertaking;
- C other related undertakings of undertakings with participation in the insurer (participating undertaking).

As it can be observed the proposal first defined a narrower circle, involving insurers and reinsurers related to each other, and then a broader circle that already includes all related undertakings, irrespective of the type of the enterprise. It is important to distinguish between the two circles because the regulation and the HFSA's responsibilities differ in the two circles. The EU Directive provides the calculation of the capital requirement on a consolidated basis only for the first, narrower circle. The calculation of this consolidated capital requirement is called adjusted solvency calculation by the EU and it is only applied to insurers, thus other types of undertakings are not included as it has to be done by credit institutions and investment firms. There are three methods for the adjusted solvency calculation:

- A Deduction and aggregation method;
- B Requirement deduction method;
- C Accounting consolidation-based method.

According to the Directive in the European Union any country may decide which of the three methods it intends to universally employ, or to entitle its supervisory authority to prescribe the mandatory application of one of the methods for any insurer. Having studied the practices of a few major EU countries we are proposing to include a few considerations in the act to determine what methods certain insurers should employ. Accordingly, for insurers obliged to prepare consolidated annual reports, employment of the method based on accounting consolidation is prescribed. For the rest of the insurers the prescribed method of calculation is the "deduction and aggregation method". The use of the requirement deduction method is dependent on individual licensing by the HFSA.

At the same time the proposal determines the reporting obligations for the entire, broadly conceived circle, together with the HFSA's supervisory licenses, which essentially correspond to the proposals concerning the ACIFE and the Capital Market Act. The proposal also regulates the HFSA's international cooperation with other supervisory authorities the same way as the other two acts.

With respect to the broadly understood circle the HFSA's main task is to control transactions within groups and to assess through that the potential risks that institutions belonging to the group in the broad sense could threaten the insurers' prudential operation with. The HFSA must especially watch out for investments, re-insurances costs, elements eligible for the calculation of the capital requirement, debt securities, loans, guarantees and other future liabilities.

In the supplementary supervision of subsidiaries of insurer holding companies, reinsurers or third country insurers the parent companies should be regarded as insurers according to the proposal and the holding companies' capital requirement should be taken as zero, while in case of reinsurers and third country insurers the capital requirement should be calculated in the way mentioned earlier (according to the calculation of the adjusted solvency capital).

In the calculation of the adjusted capital all funds originating from related undertakings that have not provided the insurers and the HFSA the information necessary for the calculation of the adjusted solvency are to be deducted, furthermore, the appreciation settled against such funds could not be taken into consideration either. (These provisions are identical with those in the other two bills.)

The adjusted solvency capital shall be calculated for the last day of the year and shall be sent to the HFSA together with the annual report. In the event the amount of the adjusted solvency capital is less than the calculated requirement, a financial rehabilitation plan for solvency capital deficit must be prepared and its rules must be followed. If the rehabilitation plan proves unsuccessful the HFSA shall be entitled to take the measures prescribed by the Insurance Act (such as calling together the general meeting, suspending dividend payments, limiting or banning the right of disposal related to technical reserves and solvency capital, etc.).

In respect of the proposals concerning the Insurance Act it must definitely be noted that these rules represent an empty set at the moment, as there are no insurance groups in Hungary yet.

For that reason the proposals to amend the Insurance Act are mostly needed in order to ensure legal harmonization with the European Union.

ANNEX No. 3

Flash Report on the Extraordinary Consolidated Data Supply

Data Supply Requirements

HFSA ordered an extraordinary report from Hungarian banking groups to reflect conditions as of December 31, 2001 with a July 31, 2002 submission deadline for the preparation of an impact study of the proposed legislative amendment related to consolidated supervision, and for the inspection of the compliance of banking groups with capital requirements and large exposure and investments limits on a consolidated basis. The resolution requesting the report was sent to 20 banks qualifying as parent companies. 21 banks¹² submitted the report, one of which did it voluntarily.

The HFSA requested extraordinary reports from those institutions, which had subsidiaries to be involved in supervisory consolidation or jointly controlled undertakings according to the HFSA's records and prepared consolidated balance sheets according to the Hungarian standards. (The consolidation techniques were known to them.) HFSA intended to implement data supply on a consolidated basis in a way that ensured that consolidation for supervisory purposes would present the least possible additional burden for the institutions involved in the consolidation, i.e. to match accounting consolidation as much as possible. Compared to the bill this led to discrepancies in two minor areas:

- those enterprises must be regarded as being jointly controlled, if they meet the criteria of joint control as per Act C of 2000, which requires at least a 33 percent direct and indirect ownership ratio (in contrast to the 20 percent required by the directives);
- exemption from consolidation was up to the parent company's discretion in line with the Hungarian accounting consolidation provisions and was not tied to quantifiable limits.

In both respects the bill took the directive into consideration.

Companies registered in and outside of Hungary equally had to be taken into consideration in the consolidation made for reporting purposes, similarly to accounting consolidation.

Subsidiaries that qualify as

- credit institutions;
- financial undertakings;
- investment firms;
- investment fund managers;
- ancillary undertaking

¹² With the exception of two minor institutions this covers the 18 banking groups mentioned in Annex No. 1 and include 5 banks, which only involved ancillary undertakings in the consolidated calculations.

are to be fully consolidated, while jointly controlled companies of the above types are to be included according to their participation, provided that in the latter case the controlling credit institution (parent bank) assumes liability up to the its actual participation.

According to the proposed amendment, in contrast to reporting, following the regulatory practices of EU member states and assessing the types of risks associated with investment fund managers, investment fund managers shall only be included in consolidation, if the HFSA deems necessary.

According to the Accounting Act insurance institutions, or undertakings outside of the financial sector that qualify as subsidiaries, or jointly controlled companies shall be treated similarly to associate undertakings in supervisory consolidation, their participation should be assessed using the method employed in case of associated enterprises. However, it must be noted that according to the Hungarian accounting rules parent companies may decide whether the associate undertakings are included in their consolidated balance sheets at book value or using the equity method. However, in the latter case undertakings may only be valued less and not more than the book value.

In case of consolidated supervisory calculations determining the voting rights and participation the controlling credit institutions (parent banks) registered in Hungary had to decide according to the rules set forth in the Accounting Act which undertakings would be regarded as

- subsidiaries;
- jointly controlled companies; and
- associate undertakings.

The subsidiaries of subsidiaries had to be treated according to the Accounting Act.

In calculating the regulatory capital the general risk provisions and the cumulative preferential shares were included in subordinated capital. In deducting (from the sum of core capital and subordinated capital) the sum of qualifying participations in credit institutions, financial and investment enterprises and the non-qualifying participations in these undertakings exceeding 10 percent of the regulatory capital, furthermore, in the capital cover for 8 percent of the adjusted total assets we equally took the regulatory capital composition permitted by the regulation into consideration, thus optimally allocating the capital necessary to meet the capital requirement.

Setting the capital requirement against foreign exchange risks, commodity risks and trading book risks we simplified reporting by calculating the capital requirement as the sum of the capital requirement of the institutions that individually calculated capital requirement. This way we undervalued the risk because we did not investigate the capital requirement against foreign exchange risk in case of financial undertakings and ancillary undertakings. As for the impact study in our opinion the degree of the resulting inaccuracy is less significant than the extra work that would have been needed to complete the calculations at the institutions that had to submit reports. At the same time using the “aggregation” method at institutions that satisfy the netting requirements the using directive’s method results in overvaluing the risks. The two effects offset each other to a certain degree.

In order to cover foreign exchange risks, commodity risks and trading book risks we allowed the inclusion of supplementary capital up to 200 percent of the core capital remaining after the deduction of 8 percent of the risk weighted assets from the regulatory capital in accord with the proposal for legislative amendment, which consisted of at least 2-year subordinated

loan capital and the part of the subordinated capital that could not be included in the regulatory capital. At least one third of the capital requirement against foreign exchange risks, commodity risks and trading book risks had to be covered by core capital in the reported data in accord with the proposal for legislative amendment.

Quality of Data Supply

Because of the novelty of the report and its deviations from effective Hungarian statutes the quality of data supply was somewhat below the level we were accustomed to in case of individual bank reports. We could correct only the most obvious errors for the flash report.

In case of several banks that were obliged to prepare consolidated reports the managing the discrepancy between what had to be involved in supervisory consolidation and what in accounting consolidation run into difficulties.

Banking groups' Composition

The relatively large number of ancillary enterprises among the undertakings included in the consolidation may be regarded as a particular Hungarian market feature. This may primarily be explained by the fact that the banks transferred several activities into ancillary undertakings where it presented a tax advantage (real estate management) and/or advantages with respect to the calculation of the capital requirement (software) for them.

Generally the number of firms to be fully or pro-rata included in the consolidation by the banks that were obliged to submit reports was small compared to medium size international banking groups; only one-seventh of the banks reported 10 or more firms. This could partly be explained by the fact that in case of some of the groups the Hungarian consolidation represented a subconsolidation level, as several groups were owned by foreign credit institutions or financial holding companies. On the other hand, financial undertakings or investment firms that counted as Hungarian subsidiary banks' "sister company" were not included in the consolidated calculations.

Key Characteristics of the Banking Groups

Of the 21 banks that submitted information 10, i.e. almost half of the banking groups, accounted for 87 percent of the groups' consolidated total assets and risk-weighted assets. Comparing the share in the consolidated risk weighted assets and the share in the consolidated total assets one may roughly estimate the individual banking groups' relative willingness to undertake exposure. A positive difference suggests greater, a negative difference suggests relatively smaller willingness. Fierce competition among mid-size banking groups and their aggressive business approach indicate that their share in the total assets is smaller than in the risk-weighted assets. At the same time the banking group that has the largest market share has a lot smaller portion of the consolidated total assets, than from the risk weighted assets.

Generally, in terms of the proportion of the banking groups' consolidated total assets only differed significantly from the parent banks' total assets in case of a few banking groups, which was related to the fact that normally few undertakings had to be included in the consolidation, and those sizes were relatively modest compared to the parent banks. In case of 14 banking groups the consolidated total assets differed by less than +/- 1 percent from the parent banks' total assets.

Capital Structure

Of the banking groups submitting information deductions because of qualifying participations in non-consolidated financial and investment undertakings had any significance in case of four groups only. The rate of deductions compared to the pre-deduction regulatory capital always remained below five percent.

The ratio of supplementary capital and primary capital in the regulatory capital available to cover credit risks, foreign exchange risk, commodity risks and trading book risks was on average 26.1 percent in the 21 banking groups. The biggest, approximately 60 percent value suggests that, if needed, the banking groups' capital could be also reinforced by inclusion of additional capital, as it could be considered up to 100 percent of the primary capital for the regulatory capital. This information also indicates that risks are normally covered in the Hungarian banking system by the most stable and secure types of capital elements.

Capital requirement was not defined against foreign exchange risks, commodity risks and trading book risks by 7 of the 21 banking groups. Of the remaining 14 banks Tier 3 capital for covering foreign exchange risks, commodity risks and trading book risks was not available at 8 banking groups, therefore, these risks were covered by the banking groups mentioned by core and subordinated capital. In case of the other 6 banking groups Tier 3 capital consisted exclusively of subordinated capital that could not be considered for covering credit risks¹³, and none of the banking groups included short-term subordinated loan capital.

The ratio of registered capital in the consolidated primary capital was on average 58.7 percent, however, in case of two big groups it was below 20 percent.

The share of outside members and other owners exceeded 1 percent of the consolidated primary capital in case of 4 banking groups only, for the rest of them it was below that level.

Consolidation differences generally reduced the primary capital by a modest amount, however, the deviation was significant. In case of some banking groups the consolidation differences considerably decreased the regulatory capital, while in case of others they increased it substantially. As these groups mostly have significant market shares, we have to continue studying the justification for the inclusion of the consolidation difference in the regulatory capital and it should be assessed in each and every case on an individual basis.

Capital Adequacy

The EU's Capital Adequacy Directive (CAD) define capital adequacy as the difference between the available regulatory capital and the capital requirement related to credit risks, foreign exchange and commodity risks, trading risks and other risks defined by the supervisory authorities. This difference was positive in each of the surveyed banking groups. However, the absolute size of the capital surplus does not allow drawing any conclusion on the capital surplus compared to the relative capital requirement. This is determined by the "capital adequacy ratio" defined as the ratio of the available and the required capital. Looking at the arithmetic average of the capital adequacy ratio submitted by the banking groups from it can be seen that on average three times the required amount of capital is available. The ratio's median was 2, reflecting twice as much capital available, than the capital requirement.

¹³ This is a type of subordinated loan capital that cannot be used to cover credit risks because of statutory limitations (the 50 percent limit of the original capital and the required 5-year residual maturity); however, it can still be used as part of the supplementary capital to cover other risks.

The ratio showing the relative sum of capital adequacy was between 1.25 and 1.32 in case of the five banking groups showing the lowest values.

Recalculating the required capital for risk the “capital adequacy ratio” completely matches the Basel-type “total capital ratio”, which compares the available regulatory capital to the risk weighted assets, representing the credit risk related capital requirement, and to the 12.5 times of the capital requirement covering foreign exchange risks, commodity risks and trading risks. Therefore, 12.5 times the “total capital ratio” is identical to the “capital adequacy ratio”. The median of the “total capital ratio” was 16 percent in case of the banking groups submitting information, twice the 8 percent, while the arithmetic average of the banking groups’ ratios was 24 percent. Because of the relation between the “total capital ratio” and the “capital adequacy ratio” the lowest values were seen at the very same banking groups where the ratio showing the relative size of capital adequacy was the lowest. At these groups the “total capital ratio” was between 10 and 10.6 percent.

In general the “total capital ratio” calculated on a consolidated basis gave much better values, than the “total capital ratio” of the banks (regarded as parent institutions in the consolidation) on an individual basis. Five banking groups are exceptional; their ratio calculated on individual basis was somewhat better than the one calculated on consolidated basis. Nevertheless the difference remained below one percentage point in case of all the five groups.

The figures indicating significant capital surplus suggest that at the end of 2001 would not have seen capital shortage at any banking group even in case of even more accurate calculations.

Large Exposures

It may be the case that certain banking groups were not able to measure group-level risks completely accurately in the calculation of large exposures, especially because the limitation did not concern individual clients, but client groups rather.

Based on the submitted report the total value of large exposures taken on a consolidated basis was far below the statutory limit of eight times the regulatory capital, similarly to what was seen in case of individual banking calculations. The average is about 1.5 times the regulatory capital. True, it is partly due to the fact that short-term exposure to credit institutions is only weighed at 20 percent. The ratio of large exposures on regulatory capital was only 3.4 and 3.7 even in case of the two banking groups with the highest figures. True, it is partly due to the fact that short-term exposure to credit institutions is only weighed at 20 percent.

In contrast to that the limit on individual client groups, determined at 25 percent of the regulatory capital, was exceeded on a consolidated basis by as many as six banking groups according to the reported figures. Considering that no limit violation could be detected on individual basis in case of most of the groups, the reasons are to be further investigated. Especially, because it happens among the banking groups that the limit is exceeded not only with respect to a single client group. One possible explanation for the phenomenon is that banks have been so far willing to share the risk with members of the group only in case of the best clients.