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MAGYAR NEMZETI BANK

ANNUAL REPORT

2011 Business Report and Financial Statements of the Magyar Nemzeti Bank

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2011 business report of the Magyar Nemzeti Bank

1 The Governor's foreword

In 2011, the annual average rate of inflation was 3.9 per cent. For most of the year, inflation fluctuated close to the upper edge of the 3±1 per cent tolerance band, which is still considered acceptable ex post in terms of meeting the inflation target. Demand side inflationary pressure has been low since the beginning of the crisis, although it has not completely offset the inflationary pressure stemming partly from tax increases and partly from items outside of core inflation. In the second half of the year, the gradual fading of the upward effects on inflation of cost shocks and continued weak domestic demand pointed to a decline in the consumer price index, but the measures affecting indirect taxes resulted in another acceleration of inflation.

In early 2011, the Monetary Council continued the tightening cycle launched at the end of the previous year. This was justified by the persistently above-target consumer price index and the upside risks surrounding the forecast. The level of the central bank base rate increased to 6 per cent in January. In the Council's judgement, the increase in the base rate mitigated the risks to inflation to a reassuring extent, and maintaining the level of the base rate for an extended period of time has made the inflation target achievable by the end of 2012. The June issue of the Quarterly Report on Inflation did not reflect any significant change in the assessment of macroeconomic conditions, and therefore, the Council maintained the 6 per cent base rate level.

Deteriorating growth prospects resulted in a further decline in inflation risks in the third quarter. Nevertheless, as a consequence of the persistent weakening of the exchange rate owing to the significantly worsening of Hungary's risk perceptions and the announced indirect tax increases, the September inflation forecast indicated an inflation rate exceeding 3 per cent in 2012. The inflation target seemed to be achievable after the fading of the inflationary effects of the tax increases. The Council left the central bank base rate at an unchanged level until November. By November, however, the exchange rate, which was weakening as a result of the deterioration in risk perceptions, already jeopardised achievement of the inflation target and also added to the vulnerability of the financial intermediary system. Accordingly, at its meeting in November the Monetary Council decided to raise the central bank base rate by 50 basis points. The December inflation forecast confirmed the Council's macroeconomic assessment, and consequently the Council raised the base rate by another 50 basis points to 7 per cent at the end of the year.

Over the long term, monetary policy can best contribute to a predictable macroeconomic environment and economic growth by maintaining price stability and ensuring the stability of the financial system. Indicators capturing the longer-term inflation outlook pointed to subdued inflationary pressure for the entire year. Due to the impact of weak domestic demand and the loose labour market on the price and wage-setting behaviour, the second-round effect of cost shocks only appeared in the price index in a subdued manner. In the future, the Monetary Council will continue to conduct its monetary policy to ensure that the medium-term development of the consumer price index is in line with the inflation target.

In 2011, the Hungarian financial system was simultaneously hit by strong external and domestic shocks. One external factor to be highlighted is the debt crisis in the euro area peripheral countries, which increased the uncertainty related to the euro area banking sectors. In terms of domestic factors, the most important risk factor is the rapidly deteriorating portfolio quality and the negative income effect of early repayment of foreign currency loans on the Hungarian banking system. Overall, the risk factors considerably reduced the capital buffers of Hungarian banks, while FX funding availability also narrowed. Banks' low willingness and weakening ability to lend was mainly reflected in the further decline in corporate lending activity. The strong balance sheet adjustment of the banking sector makes the commencement of economic growth extremely difficult.

In 2011, the Government took several steps to reduce the burdens on households with foreign exchange mortgage loans. The most important element of this series of measures was early repayment at a preferential exchange rate, the introduction of which was not supported by the Magyar Nemzeti Bank (MNB) due to the significant risks and unfavourable side effects of the scheme. However, in order to ease the foreign currency demand pressure, the amount of foreign exchange required for the early repayment of foreign currency loans was made available by the MNB from the country's foreign exchange reserves.

In the euro sale tenders announced on 3 October 2011, the MNB made available a total of EUR 1,600 million for the banking sector until the end of 2011. By the end of the year, EUR 862 million of this amount was actually used by credit institutions.

In order to reduce the burden on foreign currency debtors, with the involvement of the MNB, the Government prepared a new, comprehensive programme starting from 2012. The key elements of the package are an exchange rate fixing programme at a preferential exchange rate and the conversion of non-performing foreign exchange based mortgage loans into forints, combined with a partial cancellation of debt. The MNB welcomed the agreement between the banking sector and the Government, and especially the fact that the agreement took into account how much burden the banks, their clients and the state are able to bear.

In relation to the closing of positions at the end of the year, similarly to the previous year, recourse to the euro/forint FX swap instruments of the MNB increased in 2011 as well. In order to support the foreign exchange liquidity management of domestic credit institutions and the transmission of the central bank base rate, in the last week of 2011 the MNB announced a one-week FX swap tender facility in addition to the existing overnight and three-month tenders. The new facility contributed to the decline in one-week swap premia and the fact that at the end of 2011 holdings of the overnight and three-month facilities did not reach the levels observed one year earlier.

Several initiatives of the MNB to amend financial legislation were accepted in 2011. In the area of the regulation of lending to households, the transparent pricing of loans and the proposal for a positive debtor list deserve mentioning. As a result of a joint initiative of the Bank and the HFSA, at the end of 2011 the Government approved a liquidity regulation package covering the banking sector. A part of the package is the regulation of the minimum requirements aiming at ensuring a short-term, 30-day liquidity buffer and the strengthening of maturity matching in foreign exchange positions.

During 2011, the amount of official foreign exchange reserves increased by EUR 4.1 billion to stand at EUR 37.8 billion at the end of the year. The increase was primarily attributable to transfers received from the European Union, amounting to EUR 4.3 billion. Of the debt management items, bonds issued by the Hungarian Government with a face value of USD 4.25 billion and EUR 1 billion also contributed to the increase in reserves. The own return on foreign exchange reserves amounted to nearly EUR 0.9 billion. Other debt management related items of the Government Debt Management Agency (sale of private pension fund assets, mark-to-market account movements, etc.) resulted in a net increase of EUR 1 billion. On the other hand, reserves were reduced by the maturing of two bonds with a face value of EUR 1 billion each and repayment of a EUR 2 billion loan from the European Commission. In addition, disbursements in foreign currency commissioned by budgetary institutions reduced the level of reserves by around EUR 2.1 billion.

In 2011, the MNB paid particular attention to low-value, basically retail and corporate payments, and published several studies on this subject. Considering that payment instruments which use less cash and fewer paper-based solutions and which prefer electronic payment solutions allow significant savings at the level of the society, the Bank formulated several proposals regarding cashless payments. Discussions on these proposals started with the Government during the year, and, as a result, several concrete ideas and amendments to the relevant legislation are being elaborated. In the first half of the year, supporting the work of the Hungarian EU presidency, the MNB participated in the process of formulating the regulation regarding the migration end date related to the Single Euro Payments Area (SEPA) and in the legislation procedure regarding the operation of the European financial infrastructures (EMIR)[1]. The implementation of the system allowing the intraday clearing of payment orders continued; starting from 1 July 2012 it will shorten the settlement of electronically submitted payment orders from the current one day to a maximum of 4 hours.

Last year, with increasing turnover both in terms of volume and value, VIBER operated with an availability exceeding even the level of international expectations. In 2011, on-site payment inspections were conducted at 16 payment service providers. The findings of the inspections suggest that some of the inspected institutions still do not fully comply with the requirements of the relevant MNB decree.[2] Consequently, fines were imposed in several cases.

In 2011, the total value of cash in circulation increased at a faster pace than in the previous year, reaching HUF 2,693 billion by the end of 2011, a 14 per cent year-on-year increase. By the end of the year, the value of currency in circulation as a proportion of GDP increased from a level that had already been considered high in international comparison to nearly 10 per cent, an all-time high in Hungary.

By the end of 2011 the number of counterfeit forint banknotes declined by 60 per cent compared to the previous year. In the light of the favourable data, the Bank focused on counterfeit

[1] European Market Infrastructure Regulation.

[2] MNB Decree No. 18/2009 on Execution of Payment Transactions.

prevention and preparations against counterfeiting. Accordingly, in 2011 it provided significant support to the activity of the commercial sector, which plays a key role in the elimination of counterfeits. Within the framework of free on-site trainings, MNB experts familiarised thousands of cashiers with the most up-to-date methods of banknote checking, and the Bank provided financial support as well to encourage a more wide-spread use of modern UV-A/C lamps to detect counterfeit banknotes.

Following the successful coins-held-to-order programme of past years, the MNB took further steps to strengthen its wholesale service provider role by putting into effect and operating a limited notes-held-to-order (NHTO) scheme for credit institutions and the Hungarian Post.

As a result of production rationalisation, efficient inventory management and the decisions taken in the past years in connection with the denomination structure (withdrawal of 1- and 2-forint coins and the replacement of 200-forint banknotes with coins), the costs of cash production declined by nearly 50 per cent in 2011. Over the longer term, savings in the tens of billions of forints can be expected from these strategic decisions.

In 2011, the MNB recorded a profit of HUF 13.6 billion, an improvement of HUF 55.2 billion compared to the loss in 2010. This improvement is mostly attributable to a considerable increase in realised profit originating from changes in the foreign-exchange rate. This increase was caused by the weakening of the exchange rate of the forint observed in the final months of the year and foreign exchange sales, which increased due to the euro sale tenders introduced in connection with the early repayment of foreign exchange mortgage loans. On the other hand, profit from financial transactions increased, which can be explained by the developments in foreign exchange market returns.

In 2011, the Bank once again achieved substantial savings of more than HUF 900 million in operating costs, which declined by 7 per cent compared to the expenditures in the previous year. In 2008, the year when the project to improve operational efficiency was launched, the operating costs of the MNB amounted to HUF 14.9 billion. The total savings achieved in the past three years is more than HUF 3 billion at annual level, which means a decline of over 20 per cent in nominal terms compared to the expenditures in 2008. These savings became possible primarily due to the initiatives included in the project and a change in focus, resulting in an emphasis on cost-effective solutions. In addition, the favourable results were also attributable to the changes in legislation that took place in the meantime and entailed a fall in costs. The 2011 operating costs in nominal terms did not reach HUF 12 billion, which is unprecedented in the past decade. The value of investment implemented in 2011 amounted to HUF 775 million, which is considerably lower than the figures for earlier years. This is partly attributable to the fact that the investment plan was already smaller compared to the value of the investment expenditures of the previous year. The underlying reason is that the high-cost investment related to the installation of workplaces in the central building had been completed in 2010, and the 2011 developments related to the IT strategy also did not entail an investment appropriation exceeding those of previous years. In addition, the completion of several development projects was postponed to 2012, and many devices were procured at a lower price than planned. Moreover, the Bank implemented some IT developments using internal resources, which also resulted in savings.

As a result of several years of efforts, the Bank's performance in the field of environmentally conscious activity has been improving year by year. In recognition of its achievements, in the institutional category the MNB was awarded the title 'The Greenest Office of 2010'. Since 2011, the Bank has continued its environmentally conscious activity in an institutionalised framework. The Environmental Management and Audit System of the MNB was developed and introduced on the basis of the so-called EMAS (Eco-Management and Audit Scheme) Regulation of the European Council. This environmentally-oriented management system provides the framework for the implementation of the objectives laid down in the Environmental Policy of the Bank and for the ongoing improvement of the environmental performance of the MNB.

In addition to its basic statutory tasks a key objective of the MNB is to contribute to the development of the financial literacy of the population and especially of the young. Therefore, for several years it has organised programmes for the population and especially for students to form their attitude and increase their financial knowledge. At the end of 2008 the Bank decided to set up a Financial Literacy Centre. In the past three years, the earlier series of successful central bank programmes was expanded with several new initiatives.

Overall, in my judgment, the operation of the Magyar Nemzeti Bank was successful in 2011.

23 April 2012, Budapest

András Simor
Governor of the Magyar Nemzeti Bank

2 A brief overview of the Magyar Nemzeti Bank

Company name: Magyar Nemzeti Bank
Registered office: 1054 Budapest, Szabadság tér 8–9.
Form of operation: company limited by shares. Pursuant to the MNB Act, the form of operation, i.e. the designation 'company limited by shares' or its abbreviation, need not be indicated in the company name of the MNB.
Year of foundation: 1924
Owner (shareholder): the Hungarian State, represented by the minister responsible for state budget
Scope of activities: as defined by the MNB Act
Subscribed capital: HUF 10 billion

2.1 OBJECTIVES AND BASIC TASKS OF THE MNB

The Magyar Nemzeti Bank is a legal entity operating as a special company limited by shares, which conducts its operations as provided for by Act LVIII of 2001 on the Magyar Nemzeti Bank (hereinafter referred to as: the MNB Act).[3] The Magyar Nemzeti Bank is a member of the European System of Central Banks.

In accordance with Article 127 of the Treaty on the Functioning of the European Union, the MNB Act, which establishes the Bank's primary objectives and basic tasks as well as its institutional, organisational, personal and financial independence and operation, stipulates that the primary objective of the MNB is to achieve and maintain price stability. Without prejudice to its primary objective, the MNB supports the implementation of the economic policy of the Government, using the monetary policy instruments at its disposal.

In addition to implementing (achieving and maintaining) price stability, and in order to achieve this objective, the Bank performs the following basic tasks specified in the MNB Act:

– it defines and implements the monetary policy;

– it has the exclusive right to issue banknotes and coins, including commemorative banknotes and coins, qualifying as legal tender;

– it creates and manages official reserves in foreign exchange and gold;

– it conducts foreign exchange operations in relation to the management of foreign exchange reserves and the implementation of exchange rate policy;

– it develops and regulates the domestic payment and settlement systems as well as securities settlement systems, and, as part of its oversight duties, monitors their activities in order to ensure their sound and efficient operation as well as smooth money circulation;

– it collects and publishes the statistical information required for carrying out its tasks;

– in co-operation with other competent authorities, it supports the efficient development and conduct of policies relating to the stability of the financial system and the prudential supervision of credit institutions.

Further to the above, the MNB may only pursue other activities based on statutory authorisation, without prejudice to the achievement of its primary objective and the performance of the basic tasks listed above.

In the spirit of central bank independence and within the framework provided by the MNB Act, the Bank independently defines the monetary policy aimed at achieving and maintaining price stability and the instruments for implementing such policy. Such instruments include, within the scope of its bank account management, accepting deposits and, subject to the restrictions set forth in the MNB Act, lending based on adequate collateral; buying and selling securities as well as acting as an intermediary of securities in the spot and derivative markets within the framework of open market operations and repurchase agreements; issuing its own securities; influencing and setting exchange rates and interest rates; discounting (rediscounting) securities; regulating minimum reserves or using other central bank instruments.

The Bank's account management services are limited to the entities defined by the MNB Act. The Bank manages the

[3] With effect from 1 January 2012, Act LVIII of 2001 on the Magyar Nemzeti Bank is repealed by Act CCVIII of 2011 on the Magyar Nemzeti Bank, which was passed by the Parliament at its meeting on 30 December 2011.

Single Treasury Account and the bank account of the Government Debt Management Agency Private Company Limited by Shares (ÁKK). In addition, pursuant to separate legislation, the Bank is entitled to manage forint and foreign exchange bank accounts for organisations performing payment services, clearing house activities, payment system operation or cash processing activities; for the central securities depository, the National Deposit Insurance Fund and the Investor Protection Fund; and, in connection with the performance of its basic tasks set out in the MNB Act, for any other domestic or foreign organisations and also for foreign organisations in respect of fulfilling obligations arising from international agreements.

2.2 THE BODIES AND MANAGEMENT OF THE MNB

The various bodies of the MNB are primarily governed by the MNB Act. The provisions of Act IV of 2006 on Business Associations apply to the MNB, with due consideration for the derogations set forth in the MNB Act.

The MNB operates as a single-member business entity. The Hungarian State as shareholder is represented by the minister responsible for state budget. The MNB operates without a General Meeting or an Executive Board. The shareholder is entitled to make decisions, by way of a shareholder's resolution, on the establishment of and amendment to the Statutes, the approval of the balance sheet and the profit and loss statement, the dividend payment from the profit for the reference year or the accumulated profit reserve and the election, dismissal and remuneration of the auditor, who guarantees statutory operations. In respect of the Annual Report of the MNB, which consists of two parts, namely the Business Report and the Financial Statements, the powers of the shareholder are separated. As regards the Financial Statements, the shareholder is entitled to exercise its right of approval, whereas in respect of the Business Report on the basic tasks, in view of the principle of central bank independence, its right is limited to the acknowledgement thereof.

The new MNB Act (Act CCVIII of 2011) effective as of 1 January 2012 entails major changes in these rules. With a shareholder's resolution the shareholder is only entitled to decide on the establishment of and amendment to the Statutes as well as the election, dismissal and remuneration of the auditor. The establishment of the accounting report of the MNB, taking the decision on dividend payment and the approval of the report on the management and financial situation of the MNB to be sent to the shareholder belong to the scope of competence of the Executive Board, which is to be newly established. The provisions of the new Act already have to be applied for the approval of the accounting report of the Bank for 2011.

In line with European Union requirements, and as an additional guarantee of independence, contrary to the practice of other companies limited by shares, the remuneration of the MNB's Governor, Deputy Governors and other members of the Monetary Council as well as the members of the Supervisory Board, are determined by the MNB Act rather than the shareholder.

In matters related to the performance of the MNB's basic tasks, the exchange rate regime and all the characteristics thereof and issues related to its role as lender of last resort for credit institutions, the MNB's supreme decision-making body is the **Monetary Council.** The members of the Monetary Council are: the Governor of the MNB, as the Chairman of the Monetary Council, the Deputy Governors of the MNB and at most 4 members elected by the Parliament for six years. The Monetary Council has at least five and at most seven members.

Each year – at the first meeting of the year – the Monetary Council elects a Deputy Chairman who substitutes the Chairman if the latter is unable to attend. In 2011, Deputy Governor Ferenc Karvalits was elected as Deputy Chairman.

In addition to the members, a representative of the Government as a permanent attendee must also be invited to the meetings of the Monetary Council. However, such representative shall not have a voting right, as, in accordance with Article 130 of the Treaty on the Functioning of the European Union, Article 1(2) of the MNB Act stipulates that: 'The MNB and the members of its decision-making bodies shall be independent in carrying out the tasks conferred upon them by the MNB Act, and shall neither seek nor take instructions from the Government, the institutions and bodies of the European Union, the governments of its Member States and any other bodies, except from the European Central Bank.'

In 2011, the members of the Monetary Council were:

- András Simor, Governor, Chairman of the Monetary Council,
- Ferenc Karvalits, Deputy Governor, Deputy Chairman of the Monetary Council,
- Júlia Király, Deputy Governor, member of the Monetary Council,
- Dr Tamás Bánfi, member of the Monetary Council (until 1 March 2011),

Members of the Monetary Council of the Magyar Nemzeti Bank

Ferenc Karvalits
Deputy Governor with general responsibilities, Deputy Chairman of the Monetary Council

András Simor
Governor,
Chairman of the Monetary Council

Júlia Király
Deputy Governor,
member of the Monetary Council

Andrea Bártfai-Mager
member of the Monetary Council
(from 21 March 2011)

Dr Ferenc Gerhardt
member of the Monetary Council
(from 21 March 2011)

Dr János Béla Cinkotai
member of the Monetary Council
(from 22 March 2011)

Dr György Kocziszky
member of the Monetary Council
(from 5 April 2011)

Members of the Monetary Council of the Magyar Nemzeti Bank

Dr Tamás Bánfi
member of the Monetary Council
(until 1 March 2011)

Dr Péter Bihari
member of the Monetary Council
(until 1 March 2011)

Dr Csaba Csáki
member of the Monetary Council
(until 1 March 2011)

Judit Neményi
member of the Monetary Council
(until 1 March 2011)

– Dr Péter Bihari, member of the Monetary Council (until 1 March 2011),
– Dr Csaba Csáki, member of the Monetary Council (until 1 March 2011),
– Judit Neményi, member of the Monetary Council (until 1 March 2011),
– Andrea Bártfai-Mager (from 21 March 2011),
– Dr Ferenc Gerhardt (from 21 March 2011),
– Dr János Béla Cinkotai (from 22 March 2011),
– Dr György Kocziszky (from 5 April 2011).

Responsibility for implementing the Monetary Council's decisions and managing the operations of the MNB rests with the **Governor of the MNB.** The Governor shall:

– supervise the performance of the basic tasks;

– supervise the internal audit organisation of the MNB with regard to the responsibilities outside the competence of the Supervisory Board;

– exercise employer's rights over the employees of the MNB (excluding the non-deputy governor members of the Monetary Council), with the exception of the powers related to the appointment, dismissal and establishment of the remuneration of the Deputy Governors;

– take all other decisions related to the governance of the operation of the MNB that do not fall within the competence of the Monetary Council.

Provisions relating to the legal status, powers, functions and operating procedures of the Monetary Council are set forth in the MNB Act, the Bank's Statutes, Organisational and Operational Procedures as well as the rules of procedures formulated by the Monetary Council.

In addition to the auditor appointed by the shareholder, the MNB is also audited by the State Audit Office and the Supervisory Board.

The supervisory competence of the **State Audit Office** in relation to the MNB is set forth in the Act on the State Audit Office. The State Audit Office audits the financial management of the MNB and its activities carried out pursuant to the provisions of the MNB Act that are not included in the basic tasks. In this regard, the State Audit Office examines if the MNB operates in accordance with

Members of the Supervisory Board of the Magyar Nemzeti Bank

Left to right: István Varga, László Madarász, Zsigmond Járai (Chairman), Dr Róbert Thuma, Dr Péter Róna, Dr Gábor András Szényei, Dr Tamás Katona, Roland Nátrán.

the applicable law, its Statutes and the shareholder's resolutions.

Prior to putting forward a proposal for the election or dismissal of the MNB's **auditor,** the President of the State Audit Office shall be consulted. The shareholder decides on the appointment, dismissal and remuneration of the auditor by way of a shareholder's resolution.

As set forth in the MNB Act, the **Supervisory Board** is the body responsible for the continuous supervision of the MNB on behalf of the owner. The supervisory competence of the Supervisory Board defined by the MNB Act excludes the supervision of the Bank's performance of its basic tasks and the impact thereof on the MNB's profit and loss. Accordingly, the report it is required to prepare pursuant to the Act on Business Associations is subject to these restrictions.

The members of the Supervisory Board defined in the MNB Act are: its Chairman elected by the Parliament, other members elected by the Parliament as well as the representative of the minister responsible for the state budget and an expert appointed by the minister responsible for the state budget. The total number of the members of the Supervisory Board and its Chairman elected by the Parliament shall be determined at the date of the commencement of the procedure for their election, by taking into consideration the number of the parliamentary panels of the ruling parties and the opposition parties in the Parliament. The Chairman of the Supervisory Board, who is elected by the Parliament, is nominated by the parliamentary group of the governing parties, whereas the other members elected by the Parliament are nominated by the parliamentary groups of the governing parties and the opposition parties.

The members' term of office coincides with the mandate of the Parliament. The Supervisory Board remains in office until a new Parliament elects new Supervisory Board members within three month from the date when the Parliament first convenes. Should the new Parliament fail to elect new Supervisory Board members within the aforementioned time-limit, the members of the Supervisory Board remain in office until the new Parliament elects the Supervisory Board members.

In 2011 the members of the Supervisory Board of the MNB were:

– Zsigmond Járai, Chairman,
– Dr Tamás Katona,
– László Madarász,
– Dr Péter Róna,
– Dr Gábor András Szényei,
– István Varga,
– Roland Nátrán (the representative of the minister responsible for the state budget),
– Dr Róbert Thuma (expert appointed by the minister responsible for the state budget).

Neither the State Audit Office nor the Supervisory Board is entitled to supervise activities qualifying as basic central bank tasks.

2.3 ORGANISATIONAL STRUCTURE OF THE CENTRAL BANK

The organisational objective of the Bank is to be excellent, both in terms of professionalism and operational conditions, and to be among the best central banks. The motto of its strategy adopted in 2007 is 'The Magyar Nemzeti Bank for Stability'. Accordingly, the most important task of the Bank is to ensure the stability required for the proper development of the economy in the fields of price stability, stability of the financial intermediary system, the payment system and the legal tender.

The organisational and management system set out in 2007 and its subsequent modifications also serve the successful, cost-effective accomplishment of these objectives.

Twenty organisational units operate within the Bank, under the control of the Governor, the two Deputy Governors and the Executive Director.

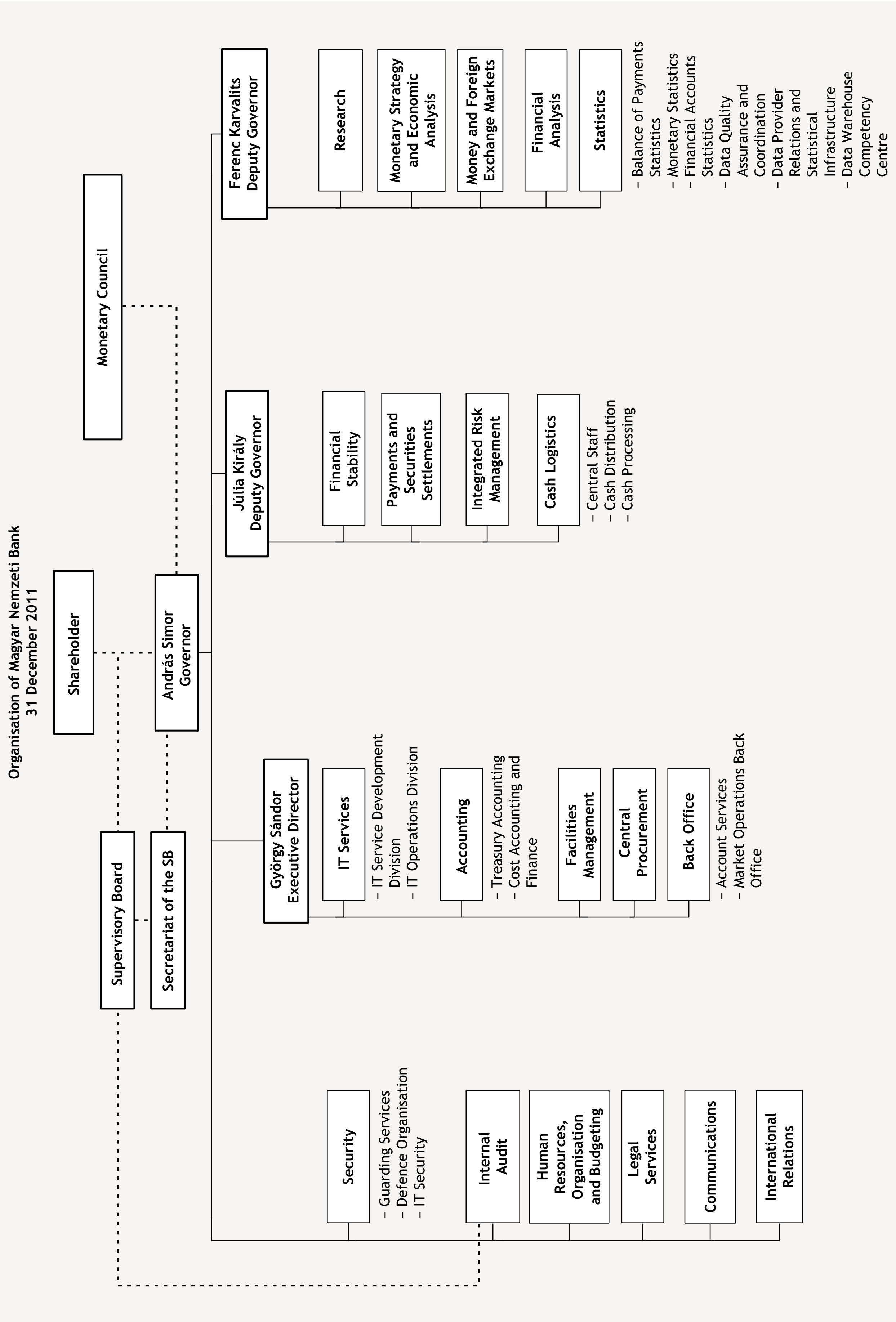
In order to provide assistance to the MNB in managing its operations, achieving the objectives and fulfilling the duties defined in the MNB Act, the Bank operates **committees in support of decision-making** with the task of discussing issues falling within the competence of the Governor, the Deputy Governors and the Executive Director, as well as supporting the process of decision-making.

The **Management Committee** is a consultative body providing assistance for the operative management of the Bank. It supports the Governor, who is responsible for managing the operation of the Bank, in decision-making, thereby ensuring the transparency of the Governor's decisions.

The **Implementation Committee** facilitates decision-making related to the implementation of the Monetary Council's decisions, by performing the necessary preparatory work and by putting forward proposals and opinions.

The responsibility of the **Financial System Overseeing Committee** is to support central bank decisions within the

Organisation chart



Members of the Management Committee of the Magyar Nemzeti Bank

András Simor
Governor

Ferenc Karvalits
Deputy Governor with general responsibilities

Júlia király
Deputy Governor

György Sándor
Executive Director

Dr Zsuzsanna Arnold Csenterics
Director
Human Resources, Organisation and Budgeting

fields of competence of the Chairman of the Committee in relation to the functioning of the institutional system, financial markets and financial infrastructure, with preparatory work, proposals and opinions.

The task of the **Investment and Cost Management Committee** is to facilitate decision-making by performing the necessary preparatory work and putting forward proposals and opinions in exercising the decision-making powers related to investment and cost management.

By performing the necessary preparatory work and putting forward proposals and opinions, the **Asset-Liability Committee (ALCO)** supports decision-making related to the Bank's foreign exchange activities affecting the Bank's balance sheet.

The **Operative Crisis Management Committee** supports the decision-making related to distressed credit institutions and discusses the results and experience of stress tests.

The organisational structure to carry out the tasks is shown as of 31 December 2011 in the organisational chart.

2.4 RELATIONS BETWEEN THE MNB AND THE EUROPEAN SYSTEM OF CENTRAL BANKS

Hungary's accession to the European Union also entailed the MNB's membership in the European System of Central Banks (ESCB). The ESCB comprises the European Central Bank (ECB), which was established in June 1998 with its seat in Frankfurt, and the national central banks of EU Member States. Its governing bodies are the Executive Board and the Governing Council, the latter consisting of the members of the ECB's Executive Board and the governors of the central banks of euro area Member States. The third decision-making body of the ECB is the General Council, which is responsible for maintaining an institutional relationship between the Eurosystem and the central banks of non-euro area Member States. Holding its meetings quarterly, the General Council comprises the President and the Vice-President of the ECB as well as the respective governors of the central banks of all EU Member States. The key responsibilities of the General Council include consultancy concerning preparations for accession to the euro area, approval of the convergence reports of the ECB and monitoring the functioning of ERM II. Within the framework of this latter activity, it assesses the sustainability of the bilateral exchange rate of non-euro currencies participating in ERM II against the euro, provides a forum for the alignment of monetary and exchange rate policies and the management of intervention and financing mechanisms in ERM II. In addition, the General Council is involved in verifying whether the central banks of EU Member States and the ECB comply with the prohibition of monetary financing of the budget and privileged access of the public sector to financial institutions. The General Council also contributes to the ECB's advisory functions and to the collection of statistical information; it must be consulted in respect of any changes in the rules of accounting and financial data supply, as well as issues related to the adjustment of the ECB's key for capital subscription. The mandate of the General Council will expire on the date when all the Member States have adopted the euro.

In 2011, the number of ESCB members did not change, but, with the adoption of the euro as of 1 January 2011 in Estonia, the number of euro area Member States increased to 17.

ESCB members are also owners of the ECB. The respective ownership shares of Member States are determined according to their shares in the GDP and total population of the EU (on the basis of statistical data compiled by the European Commission). As of 29 December 2010, the ECB increased its subscribed capital by EUR 5 billion, from EUR 5.76 billion to EUR 10.76 billion.

Currently, euro area central banks subscribe to 70 per cent of the ECB's capital, while the remaining 30 per cent is divided among the central banks of non-euro area Member States. These latter central banks pay a pre-defined minimum percentage of their respective subscriptions to the ECB's capital as a contribution to the operational costs of the ECB that are incurred in connection with their ESCB membership. With effect from 29 December 2010 this contribution of non-euro area central banks was defined as 3.75 per cent of the respective subscriptions (previously it was 7 per cent).

Following the capital increase of the ECB in December 2010 and the amendment to the regulation concerning the payment contribution of non-euro area central banks (reducing the pre-defined percentage of subscriptions to be paid from 7 per cent to 3.75 per cent), the share of the MNB in the ECB's capital did not change as from 1 January 2011 (i.e. it remained 1.3856 per cent). The capital increase, however, raised the amount of its paid-up capital to EUR 5.591 million, requiring the MNB to pay additional capital contribution in the amount of EUR 3,863.01 at the end of 2010. No further change took place in the MNB's share in the capital of the ECB during 2011.

The ESCB Committees play an important role in the work of the ECB's decision-making bodies. The basic role of these committees is to prepare decisions and facilitate co-ordination as per the division of the various central bank duties, covering all areas of central banking operations from monetary policy through communication to statistical data reporting. Experts from the central banks of non-euro area Member States attend those committee meetings whose agenda includes items affecting the ESCB as a whole and which fall within the competence of the General Council. (For a detailed description of the ESCB Committees and the activities of the various fora assisting them, see Chapter 3.12). The committees meet and discuss current issues relevant to their professional areas 4–5 times a year on average, according to a schedule determined for a year in advance.

The senior executives and relevant experts of the MNB continue to play an active role in the activities of these committees and their working groups. In 2011, the ESCB committee work continued to be a very useful forum for exchange of professional experience.

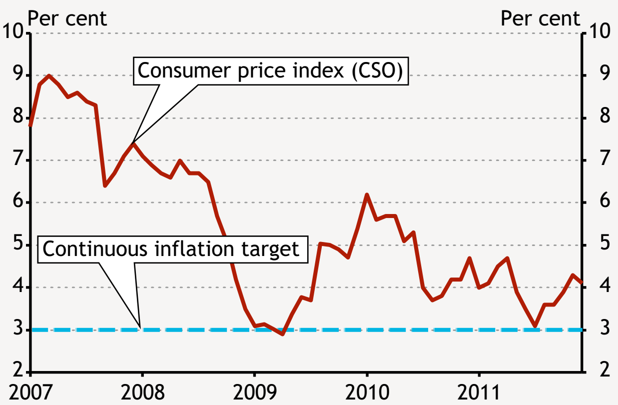
3 Review of the MNB's performance in 2011

3.1 MONETARY POLICY

Monetary policy framework

Pursuant to the MNB Act, the primary objective of the Bank is to achieve and maintain price stability. To further the goal of price stability, since 2001 monetary policy has been determined by the MNB within the framework of inflation targeting. Under the inflation targeting regime, the Monetary Council of the MNB determines a numerical value for the inflation target in line with price stability, and the monetary policy it conducts is aimed at achieving the pre-defined inflation target. The continuous inflation target of the MNB is 3 per cent. This level is low enough to minimise the inflation-generated costs that reduce social welfare, and at the same time provides protection against the risk of deflation.

Chart 1
Inflation target and inflation developments



Sources: CSO and MNB.

Trends in inflation in 2011

Average annual inflation was 3.9 per cent in 2011. In the evaluation of the achievement of the inflation target, the fluctuations stemming from unexpected effects must also be taken into account. Therefore, a consumer price index deviating from the 3 per cent target by not more than ±1 percentage point is ex post acceptable in terms of price stability. For most of the year, inflation fluctuated close to the upper edge of the resulting 3±1 per cent tolerance band.

Demand side inflationary pressure has been low since the beginning of the crisis, although it has not completely offset the inflationary pressure attributable partly to tax increases and partly to non-core inflation items. As a result of cost shocks, core inflation gradually increased from 2 per cent early in the year to 3 per cent by the end of the year. The cost shocks may also have added to households' inflation expectations; the decline in expectations observed earlier reversed.

A more detailed analysis of the developments reveals that inflation items were characterised by strong heterogeneity. Accelerating inflation in processed food prices observed early in the year was attributable to the food commodity price shock caused by unfavourable weather conditions in the previous year and strengthening price pressure from fuel prices. Annual inflation of market services fell to a historic low at the beginning of the year and remained at low levels thereafter. However, a slow increase was observed throughout the year, which may indicate that high raw material costs may have appeared in the prices of services as well, albeit in a subdued manner. Within tradable items, as a result of cost shocks, non-durable goods were characterised by accelerating price increases in the first half of the year. By contrast, changes in the prices of durables were determined by weak demand. As a result, the cost shocks only had a restrained effect on tradables prices, and the considerable depreciation of the exchange rate in the last quarter also resulted in only minor price increases.

In respect of non-core inflation items, the high inflation in unprocessed food prices observed in the first half of the year broke as a result of more favourable harvest results and showed considerable adjustment by the end of the year. Compared to commodity price increases, changes in administered prices were restrained, which also contributed to lower inflation.

The effect of indirect tax increases by the Government was contrary to the developments pointing to disinflation.

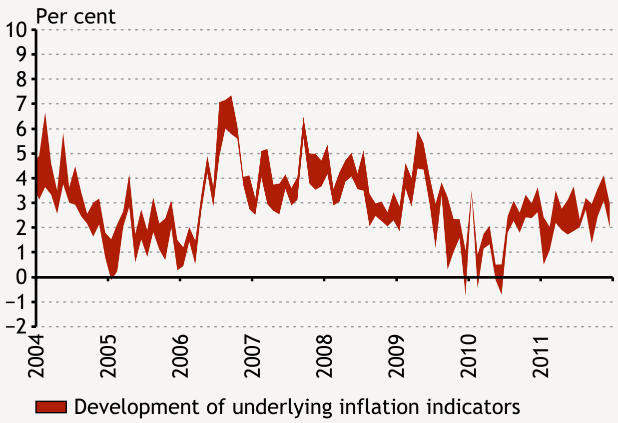
During the year, short-based indicators capturing underlying inflation and general trends indicated that weak demand

Table 1
Consumer price index and its components
(percentage change, year-on-year)

	2009	2010	2011	2011			
				Q1	Q2	Q3	Q4
Core inflation	4.1	3.0	2.8	2.0	2.8	3.1	3.1
Unprocessed food	5.0	6.6	4.3	13.9	8.0	−2.7	−1.9
Fuel and energy	−5.2	18.1	13.8	14.8	12.6	11.9	16.0
Regulated prices	8.0	6.5	4.1	4.9	3.9	3.1	4.5
Consumer price index	4.2	4.9	3.9	4.2	4.0	3.4	4.1
CPI excluding indirect taxes and subsidies	2.3	2.6	3.8	4.1	4.0	3.3	3.6

Note: In the case of price indices with unchanged tax content, the CSO adjusts the consumer price index for the technical effect of changes in the most important indirect taxes.
Source: CSO.

Chart 2
Range of underlying inflation indicators



Source: MNB.

allows only a moderate pass-through of costs. The indicators were typically within the band between 2-3 per cent in 2011 (Chart 2).

In summary, weak domestic demand and loose labour market conditions restrained the pass-through of cost shocks into core inflation. Nevertheless, mounting cost side price pressure increased processed food price inflation considerably and the inflation of tradables and market services to a lesser extent for most of the year. By the end of 2011, the increase in processed food prices slowed down, but this was offset by the slightly rising inflation of non-core inflation items. The acceleration of inflation towards the end of the year is mainly attributable to changes in the excise tax.

Monetary policy

One of the basic characteristics of monetary policy decisions is the fact that they can affect consumer prices only with a lag of several quarters. Consequently, it is essential to have a forward-looking attitude in decision-making, in other words, to estimate the most probable outcome of future economic developments. Under the inflation targeting regime, the quarterly macroeconomic forecasts prepared for a two-year time horizon are important guides for decision-making.

In early 2011, the Monetary Council continued the cycle of interest rate increases launched at the end of the previous year. This was justified by the persistently above-target consumer price index and by the upside risks surrounding the forecast. In the Council's judgement, there was a danger that inflation expectations would start to rise and cost shocks to the economy would entail second-round effects. Therefore, following the 25 basis point increases in both November and December 2010, the Council increased the central bank base rate by another 25 basis points to 6 per cent in January 2011. In February, the Council already established that this increase of the rate had mitigated inflationary risks in a reassuring manner. According to the Quarterly Report on Inflation published in March 2011, the inflation target was attainable by the end of 2012, but required the maintenance of the 6 per cent base rate level for an extended period of time.

The June issue of the Quarterly Report on Inflation did not contain any may change in terms of the inflation outlook. Based on the information available at that time, following the fading of the cost shocks, the inflation target seemed attainable by the end of 2012. Accordingly, and in line with the communication during the previous months, the Monetary Council did not change the central bank base rate in the second quarter.

In the third quarter, the Hungarian economy's growth prospects continued to deteriorate due to the debt problems in the euro area, which is Hungary's largest trading partner. Worsening prospects for business activity pointed to disinflation being stronger than expected earlier; in the judgement of the Council, inflationary risks declined considerably in the medium term. At the same time, the risk assessment of Hungary deteriorated significantly, which was reflected in the increase in risk premia and the weakening of the exchange rate of the forint. The worsening investor sentiment was primarily attributable to the euro area debt crisis and the deteriorating global growth prospects. As a result of the indirect tax increases, the inflation forecast indicated that inflation would be above 3 per cent for 2012 and then decline to below the target after the inflationary effect of the tax increases faded. Taking account of these aspects, the Council left the central bank base rate unchanged.

In the opinion of the Council, despite the weak demand environment, by November the weakening of the exchange rate, which took place due to the deterioration in risk assessment attributable to both international and country-specific reasons, made the inflation outlook even worse, jeopardising the attainment of the inflation target and also adding to the vulnerability of the financial intermediary system. Due to the deterioration in the macroeconomic outlook and the risk assessment, at its November meeting the Monetary Council decided to raise the central bank base rate by 50 basis points. The December inflation forecast confirmed the assessment conducted by the Monetary Council in November; accordingly, continuing the tightening started in November, the Council increased the central bank base rate by 50 basis points to 7 per cent. Based on the forecast, the measures concerning the VAT and the excise tax may lead to a material increase in the consumer price index in 2012, while the weakening of the exchange rate may result in a further deterioration in the inflation outlook. Following the fading of the effect of the indirect tax increases, the disinflationary effect of the persistently weak domestic demand may become dominant. The December forecast showed that the Hungarian economy may practically stagnate in 2012, and growth may start only in 2013.

Changes in monetary policy instruments

Forint market instruments

The MNB introduced the flexible minimum reserve system in November 2010. This system allows credit institutions to select their own reserve ratio from the possible 2, 3, 4 and 5 per cent ratios bi-annually. Since introduction of the system, a gradual increase has been observed in the average of the minimum reserve ratios selected by individual credit institutions. While in November 2010 the average reserve ratio increased from the earlier 2 per cent to 2.5 per cent, in November 2011 it reached a level of 2.8 per cent. The increase in the average rate reflects that, in line with the expectations of the Central Bank, the optimum reserve ratio levels for individual credit institutions vary due to the differences in their strategies and liquidity management needs. Therefore, the new system ensures a better compliance with the purpose of the minimum reserve system, i.e. the smoothing of the fluctuations of interbank money market yields by supporting the liquidity management of domestic credit institutions.

In the autumn of 2010, the MNB launched the weekly publication of the liquidity forecast capturing the expected developments in banking sector liquidity. With the expiry of the initial trial period, on 6 June 2011 the Monetary Council decided that the Bank would continue to publish the forecast on its website and on the relevant Reuters and Bloomberg pages. With publication of the forecast, the Bank intends to facilitate an optimum magnitude of recourse to the policy instrument and to achieve a declining reliance by credit institutions on the overnight lending facility and the deposit facility. As a result, overnight interbank rates may follow the changes in the central bank base rate even more closely.

As a result of the change in the schedule of Monetary Council meetings, with effect from 1 July 2011 the trade date of the two-week MNB bill auction as well as of the tenders of the two-week and six-month lending facilities changed from Tuesday to Wednesday, and the MNB also publishes its liquidity forecast on Wednesday. In relation to the deal date settlement day of these products changed from T+1 to day T, so that the settlement of the transactions should continue to fall on Wednesday.

Starting from 1 January 2012, due to the extension of the operating hours of VIBER by 1 hour, the banking system may use the overnight deposit and lending facilities of the MNB (their interest rates constitute the two edges of the interest rate corridor) 1 hour longer, i.e. until 18:30 instead of 17:30 hours.

Instruments providing foreign exchange liquidity

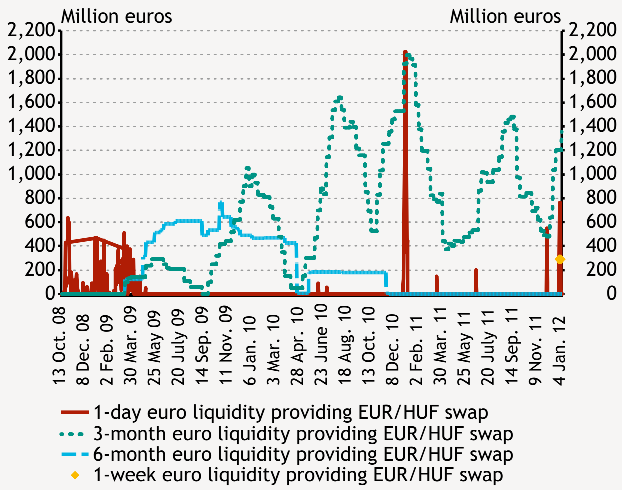
In order to offset the possible unfavourable foreign exchange market effects of the early repayment of households' foreign exchange loans at a preferential exchange rate, starting from 3 October 2011 the MNB introduced euro sale tenders, announced on a weekly basis until 29 February 2012. Credit institutions that have foreign exchange based loan agreements suitable for early repayment were eligible to participate in the tenders. The maximum extent of their participation equalled their foreign exchange denominated housing and general purpose mortgage loans outstanding on 31 August 2011. In the tenders, the foreign exchange allocated to the credit institutions is rolled by the MNB automatically within the framework of overnight euro/forint FX swap transactions until the amount of foreign exchange is expended. The credit institutions are obliged to use up as much of the foreign exchange allocated to them as the amount of early repayments that have been realised. Until the end of 2011, the MNB allocated a total EUR 1,600 million to the banking sector through this facility. Credit institutions used EUR 862 million of this amount until 31 December 2011.

In 2011, developments in holdings of the euro liquidity providing 3-month euro/forint FX swap facility were very similar to those observed in 2010. Experience shows that demand for the Bank's swap facility increases as the end of the year approaches. Presumably, the underlying explanation is that both domestic and foreign market participants pay special attention to year-end positions, as they constitute the basis for annual business reports and any taxes burdening banks. Therefore, many investors strive to place on-balance-sheet positions off the balance sheet, which may exert upside pressure on swap market foreign currency demand and thus on swap market premia.

In relation to the closing of year-end positions, in order to support the foreign exchange liquidity management of domestic credit institutions and the transmission of the central bank base rate, on 28 December 2011 the MNB announced a one-week FX swap tender. In this tender, the MNB provided foreign exchange with a total value of EUR 290 million for domestic credit institutions in exchange for forints. The new facility contributed to the decline in the one-week swap spread and the fact that at the end of 2011 the holdings of the overnight and 3-month central bank swap instruments did not reach the levels observed one year earlier. The fact that in this period no significant forint instrument sales by non-residents were seen also contributed to the relative improvement of the swap market situation at the end of 2011. Namely, at the end of the previous year the demand for foreign exchange stemming from forint instrument sales added to the tensions in the swap market.

During the year, the banking sector used the overnight euro/forint swap facility on 4 occasions. Just like a year earlier, the highest drawings also took place at the end of the year. However, while total central bank swap holdings amounted to EUR 3,944 million at the end of 2010, their amount was lower (EUR 2,256 million) at the end of 2011.

Chart 3
Recourse to the MNB's FX swap instruments – outstanding amounts



Source: MNB.

3.2 STABILITY OF THE FINANCIAL INTERMEDIARY SYSTEM

Key trends in the financial intermediary system

The MNB published its *Report on Financial Stability* on 20 April and 2 November 2011. The primary risk identified in the November 2011 Report was that strong external and domestic shocks considerably reduce the capital reserves of Hungarian banks, which may force banks to shrink their balance sheets. The adjustment may primarily affect corporate lending, making it more difficult to put the domestic economy on a growth path.

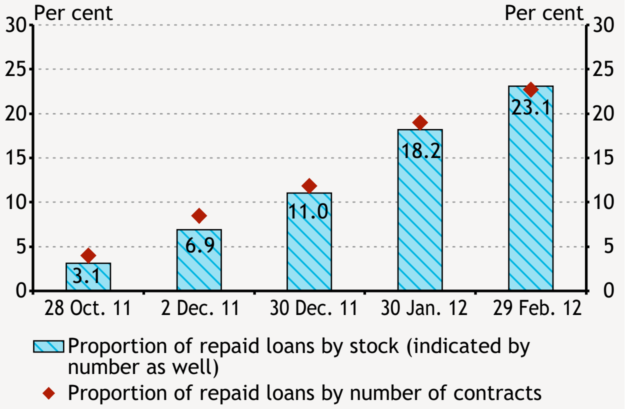
One of the external risk factors appearing in 2011 is the debt crisis of euro area peripheral countries, which adds to the chance of a recurrence of financial crisis and global recession. The European banking system holds a significant amount of government securities issued by euro area peripheral countries. Consequently, the risks of financial contagion between (the public and financial) sectors and across (euro area) countries are also high. The debt crisis of the euro area has an unfavourable effect on the performance of the Hungarian economy not only because of the dependency on exports, but also because of the reliance on external funding.

Of the domestic factors, the rapidly deteriorating portfolio quality and the negative effect of the early repayment programme on the Hungarian banking system became the most important risk factors in the second half of 2011. Due to the unfavourable macroeconomic environment, the weakening of the forint and the increase in the costs of external financing, by the end of the fourth quarter of 2011 in the corporate and household sectors the proportion of the non-performing portfolio overdue for more than 90 days increased to 17.4 per cent and nearly 15 per cent, respectively. This portfolio deterioration resulted in a substantial increase in loan losses.

The early repayment programme started in the fourth quarter of 2011. In November 2011, the MNB projected a participation rate of around 20 per cent as a proportion of total loans. Based on the data available until early February 2012 and published by the HFSA, the proportion of clients who used the opportunity of preferential early repayment was somewhat higher than the preliminary estimate: upon the closing of the programme the proportion of early repaid loans amounted to 23.1 per cent of the total foreign exchange mortgage loans of the banking sector (Chart 4). In the banking system, the early repayments resulted in a total loss of approximately HUF 360 billion for credit institutions; this amount may be reduced by HUF 110 billion due to the 30 per cent bank tax refund stemming from an agreement between the Hungarian Banking Association and the Government. Nevertheless, the proportion of loan substitutions within early repayments fell short of preliminary expectations; a ratio of 32 per cent was realised instead of the 75 per cent originally estimated by the MNB.

Due to the large proportion of those who did not participate in the early repayment programme, the gradual decline in the total amount of foreign exchange loans continues to keep the vulnerability of the Hungarian economy at a high level. The intention with the agreement between the Government and the Hungarian Banking Association reached at the end of 2011 is to manage this situation. Accordingly, the temporary exchange rate fixing programme launched in the summer of 2011 is being expanded (by its extension until mid-2017 and by sharing the difference between the fixed and the real exchange rates among the Government, the bank and the debtor), and the changing into forints of the non-performing foreign exchange mortgage loans will start, coupled with partial debt relief.

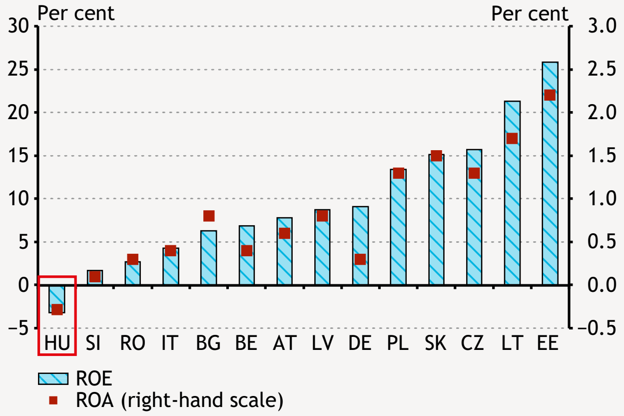
Chart 4
Proportion of early repayments done in the banking system



Note: Repaid loans as a proportion of total foreign exchange mortgage loans at end-August 2011 and as a proportion of the number of contracts at end-June 2011.
Source: MNB.

Overall, the profitability position of the Hungarian banking sector deteriorated considerably in 2011. Based on preliminary, non-audited data, 2011 ended with a loss for the banking sector (return on assets, ROA: −0.3 per cent; return on equity, ROE: −3.2 per cent). Concentration and asymmetry continue to be strong in profitability developments. The related risks are also increased by the fact that the profitability of the Hungarian banking sector is low in international comparison as well (compared to parent bank countries and regional competitors) (Chart 5). All this may result in a significant competitive disadvantage in the funding and capital allocation within international banking groups.

Chart 5
Profitability of the Hungarian banking sector in international comparison



Note: Banking data calculated from end-2011 individual-level data for Hungary; June 2011 consolidated data for the other countries. After-tax data. HU: Hungay, SI: Slovenia, RO: Romania, IT: Italy, BG: Bulgaria, BE: Belgium, AT: Austria, LV: Latvia, DE: Germany, PL: Poland, SK: Slovakia, CZ: Czech Republic, LT: Lithuania, EE: Estonia.
Sources: ECB Consolidated Banking Database and MNB.

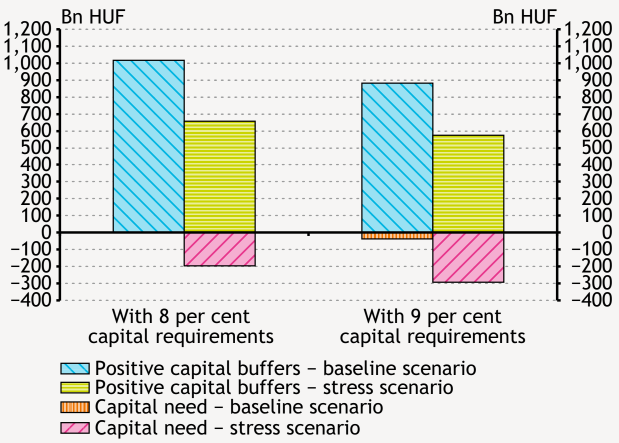
As a result of the increase in losses and the external and domestic shocks to the banking system, it became necessary for parent banks to strengthen the capital position of their affiliate banks. Taking the 8 per cent minimum capital adequacy ratio as a basis, the autumn 2011 integrated market and credit risk stress test conducted by the MNB and containing extreme economic and money market scenarios forecasted a nearly HUF 200 billion capital raising demand until the end of 2012 (Chart 6), which exceeds the results of the stress tests of the previous two years, but is below the need in March 2009. In addition to domestic factors, the increase in the size of external shocks from the euro area also contributed to the growing need for capital raising.

The commitment of parent banks is indicated by the fact that before the end of the year capital increases were carried out or intentions to carry out capital increases were announced in the magnitude similar to the one indicated in the stress test. As a result of this and the rapid balance sheet adjustment, the system-level capital adequacy ratio of the Hungarian banking sector continues to be satisfactory (13.5 per cent at the end of December 2011). Nevertheless, it is important to emphasise that in many cases parent banks carry out only the necessary minimum capital increases, without building up substantial capital buffers to increase lending.

In addition to the decline in capital buffers, the credit supply of the Hungarian banking system is significantly limited by weakening funding. In line with the earlier, strong pre-crisis lending activity, external funds play an important role in the financing structure of the Hungarian banking system. An unfavourable trend accompanying the strong balance sheet adjustment is that the foreign liabilities of the banking system declined considerably, by approximately HUF 900 billion from the outbreak of the crisis (from end-October 2008) until June 2010, and then again by some HUF 3,100 billion until the end of 2011 (by around HUF 1,300 billion in the second half of 2010; by some HUF 1,800 billion in 2011). Accordingly, between end-2010 and end-2011 some 30 per cent of external funds was withdrawn, whereas the ratio of external funds to the balance sheet total fell from 33 per cent to 26 per cent. In contrast to domestic developments, external funding declined slightly or increased in most of the neighbouring countries during the same period (Chart 7). All of this shows the narrowing of the FX funding possibilities of the Hungarian banking system, indicating at the same time the competitive disadvantage of the Hungarian banking system related to fund allocations within international banking groups.

Chart 6
Capital buffer and additional capital need of the banking system in the baseline and stress scenarios by end-2012

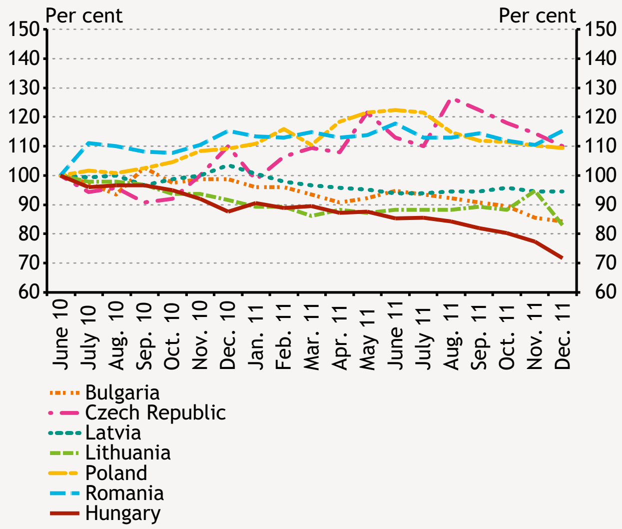
(Report on Financial Stability, autumn 2011)



Note: The additional capital need is the sum of the capital needs of the individual banks. The data for 2012 also contain the required capital increase in 2011. The chart was prepared on the basis of the stress test presented in the November 2011 Report on Financial Stability.
Main assumptions of the baseline scenario: GDP growth 1.6 per cent (2011), 1.0 per cent (2012); total employment 0.5 per cent (2011), 0.9 per cent (2012); housing prices 0 per cent (2011), 0 per cent (2012); EUR/HUF 273 (2011), EUR/HUF 284 (2012); CHF/HUF 223 (2011), CHF/HUF 237 (2012); CDS spread 450 basis points.
Main assumptions of the stress scenario: GDP growth 1.5 per cent (2011), -1.2 per cent (2012); total employment 0.4 per cent (2011), -0.5 per cent (2012); housing prices 0 per cent (2011), -10 per cent (2012); EUR/HUF 282 (2011), EUR/HUF 329 (2012); CHF/HUF 231 (2011), CHF/HUF 275 (2012); CDS spread 580 basis points (2011), 740 basis points (2012).
Source: MNB.

Chart 7
Foreign liabilities of the banking sector in international comparison

(June 2010 = 100 per cent)

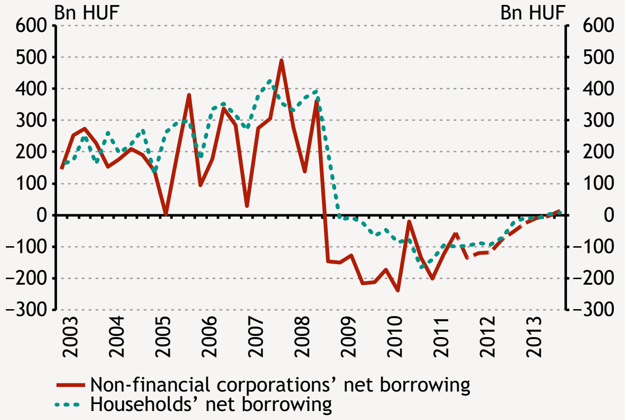


Sources: ECB and MNB.

The strong deterioration in profitability, the decrease in capital buffers as well as the rising costs and outflows of external funds jointly contribute to a significant decline in the ability to lend of the banking sector, in addition to the decline in its willingness to lend. All of this results in a low credit supply, especially in the corporate sector.

As in the previous two years, corporate loans outstanding declined considerably in 2011, and a reversal of the trend is only expected to take place at the end of 2013 (Chart 8). The decline in corporate lending is principally attributable to supply factors, explained by increasingly weak ability to lend since the end of 2011, in addition to the low willingness to lend. All of this is also confirmed by the findings of the quarterly lending surveys conducted by the Bank in 2011 as well. The low willingness to lend stems from the economic and operating environment for credit institutions and from the accumulation of non-performing loans. The weak ability to lend is attributable to the declining capital buffers and narrowing FX funding opportunities.

Chart 8
Corporate and household lending



Note: Quarterly Report on Inflation, December 2011.
Source: MNB.

Household loans outstanding also contracted markedly in 2011 (in the last quarter the decline was mainly determined by early repayment). Total loans outstanding are expected to increase only after 2013 (Chart 8). Households' credit demand is very weak as a result of the protracted balance sheet adjustment process stemming from the excessive indebtedness. The findings of the lending surveys and statistical data confirm that, in addition to the strong demand constraints, supply constraints also play an important role. An increase in supply may be attained by strengthening price competition among banks, in which the introduction of the so-called reference-interest fixed-premium loan products (on the basis of the legislation adopted in the autumn of 2011 at the initiative of the Bank) and the stimulation of the loan-switching market may play a significant role.

Government measures to handle households' foreign exchange mortgage loans outstanding

In 2011, the Government took several steps attempting to remedy the problems of foreign exchange debtors. One of these measures was the early repayment at a preferential exchange rate, which was implemented by the Government without consulting the MNB beforehand in spite of its statutory obligation, and despite the opinion formulated and made public by the MNB (without being requested to do so by the Government). This step considerably reduced participants' debt and exchange rate risk, but the programme also had significant negative effects as well. The most important of these was the damage of trust in the safety of private law contracts and the major one-off loss suffered by the banking sector; together these aspects strongly impaired the competitiveness of not only the Hungarian financial system, but also of the economy as a whole. The MNB made the amount of foreign exchange required for the early repayment of foreign exchange loans available for banks from the foreign exchange reserves of the country, in order to reduce the risk of strong demand for foreign exchange stemming from the transaction. The foreign exchange was made available in the form of euro sale tenders starting from October 2011.

In November 2011, the MNB also participated in the talks with the Government and the Hungarian Banking Association aimed at handling the burdens of households with foreign exchange mortgage loans which were unable to participate in the early repayment scheme. The agreement included a more precise definition of the early repayment programme, expansion of the exchange rate fixing scheme established earlier and the treatment of non-performing foreign exchange mortgage loans and was concluded on 15 December 2011. In the agreement, the Government and the Hungarian Banking Association declared their common commitment towards the maintenance of the stability of the financial intermediary system, the easing of the situation of households with foreign exchange mortgage loans and facilitating the upswing of the Hungarian economy. It is timely and farsighted that the parties identified predictable regulatory environment and taking account of the loadability of the financial intermediary system as the necessary preconditions for the financial intermediary system to undertake an active role.

Regulatory proposals of the MNB and participation in the implementation of regulations

In 2011 as well, the MNB participated in the initiation, preparation and elaboration of numerous legal regulations aimed at strengthening financial stability, including in particular the transparent pricing of mortgage loans for households; the amendment to the government decree on prudent lending; the elaboration of the government decree on determining the liquidity level of credit institutions and on the regulation of maturity matching in their FX positions as well as the establishment of a complete, mandatory positive debtor list.

The Bank called attention to the high interest rate premiums seen in the household segment; this phenomenon is a sign of the weak price competition typical in the household loan market. The possibility of unilaterally changing interest rates, which is typical of mortgage loans, and the short (3–12-month) interest rate period play a key role in this weak price competition and non-transparent pricing. This leads to loan switching problems, as comparison between products is made impossible by the non-transparent interest rate conditions, because the client can only know the interest rate on loans for one interest rate period in advance. Consequently, loan switching regarding the existing loans outstanding becomes impossible, as it does not make sense for consumers to assume the costs (in terms of money and time) related to the new loan in exchange for uncertain advantages. In the Country Protection Action Plan, the Government and then the Parliament as well accepted the MNB's earlier proposal reacting to the problem of non-transparent interest rate conditions, which allows the offering of two kinds of loan products to consumers: loans tied to a reference interest rate with a premium that cannot be raised or loans with an interest rate fixed for a longer period (3–5 years).

Earlier, the MNB had already proposed the creation of a positive list of household borrowers (see, for example, the November 2010 issue of the Report on Financial Stability). Within the framework of the Country Protection Action Plan, the Government and then the legislative parliamentary majority approved the setting up of the positive debtor list with its introduction in 2012. By means of this tool, the credit histories of not only bad debtors but of good ones as well will be traceable in a central registration system of debtors, making it easier for banks to assess and price the credit risk of new clients.

In the past, there was no liquidity regulation based on quantified indicators in the Hungarian banking system. In 2011, the MNB proposed the introduction of a foreign exchange funding adequacy ratio (FFAR), which also takes account of the peculiarities of the domestic banking sector. This indicator is the quotient of stable foreign exchange funds plus the net foreign exchange swap stock with a maturity over one year divided by the weighted foreign currency denominated assets outstanding with a maturity over one year to be financed; thus it is able to manage the maturity mismatch problem of the on-balance-sheet and off-balance-sheet foreign exchange positions at the same time.

The Government accepted the proposal of the MNB together with the inclusion of the daily liquidity indicators initiated by the HFSA. Starting from 16 January 2012, the operational liquidity reserves based on 30-day cash flows of credit institutions operating in the form of company limited by shares must exceed 10 per cent of the balance sheet total (balance sheet coverage indicator) or 20 per cent of total deposits from the non-financial private sector (deposit coverage indicator). Complementing one another, the regulation of the daily liquidity indicator and the indicators aiming at the strengthening of maturity matching contribute to the enhancement of the liquidity shock absorbing capacity of domestic banks.

Within the framework of the new MNB Act adopted at the end of 2011, the Governor of the MNB was authorised to issue macroprudential decrees on the basis of the decision of the Monetary Council in order to prevent the accumulation of systemic risks or to reduce these risks (see Box 1 for more details).

In addition to domestic regulatory issues, the MNB also kept track of the initiatives dealing with the financial crisis management and regulation going on in the international arena, in particular in the European Union. It commented on the CRD IV Directive serving the European implementation of the so-called Basel III regulation, and gave an opinion on the draft directive on residential real estate loan contracts elaborated by the Council of the European Union.

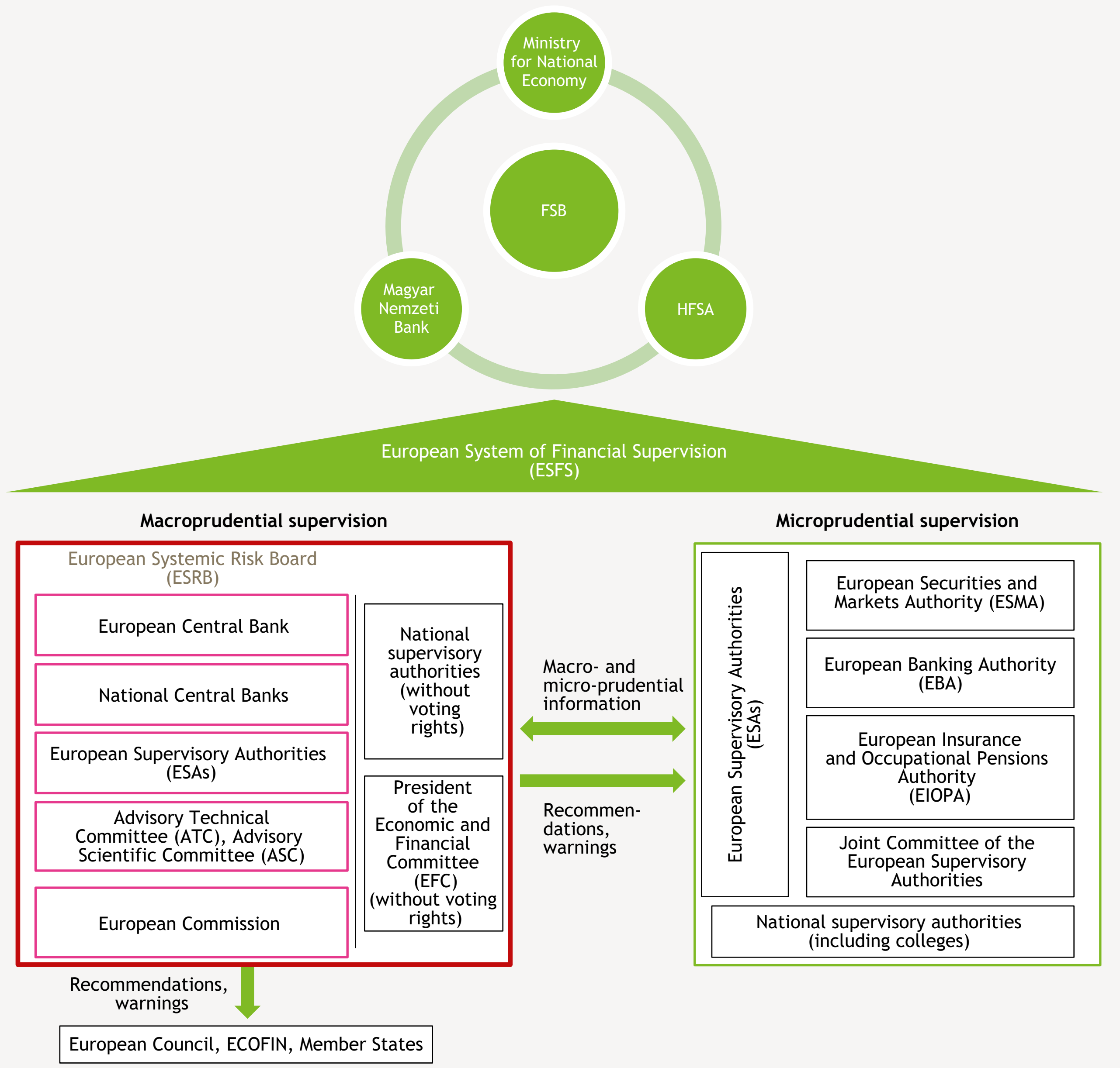
In issues concerning the financial sector the Bank also supported the work of the Hungarian EU presidency in the first half of 2011, and participated in formulating the common Hungarian position regarding the new draft regulation of the EU related to bank crisis management. Moreover, the MNB made a proposal regarding the latest draft directive on deposit insurance elaborated by the Council of the European Union, and participated in providing opinions on the so-called 'short selling' regulation and the Commission's proposal concerning a draft directive on credit rating agencies.

Domestic and international co-operation

The MNB played an active role in the work of the Financial Stability Board (FSB), comprised of the Minister for National Economy, the President of the HFSA and the Governor of the MNB (Chart 9). In 2011 as well, the activity of the FSC created harmony between the microprudential supervisory authority, which supervises the individual risks of the institutions operating in the financial intermediary system, and the macroprudential supervisory authority, which monitors systemic risks that jeopardise the financial system as a whole. The parties discussed strategic, regulatory and risk issues concerning the financial system as a whole as well as other questions of principle at the meetings of the FSC.

The European Systemic Risk Board (ESRB) and the European Supervisory Authorities were set up in January 2011. In line with its macroprudential role, the MNB participated in the preparatory work of and gave an opinion on the establishment of these institutions from the outset, and was represented at the meetings of the ESRB General Board (Chart 9). In the first quarter of 2011, the Advisory Technical Committee (ATC) was also established to support the work of the ESRB; the ATC is responsible for the technical preparation of the work of the ESRB. The MNB gave an opinion on the annual work schedule of the ATC and on the mandates of the working groups related to the ATC, and delegated experts to the working groups important for Hungary.

Chart 9
Structures of the Financial Stability Board (FSB) and the European Systemic Risk Board (ESRB) and their accommodation to the European System of Financial Supervisors (ESFS)



Box 1
Macroprudential responsibility and instruments of the MNB pursuant to the new MNB Act

One of the most important lessons from the ongoing financial and economic crisis is that the institutional structure of the supervision of the financial system needs to be reformed. One key step in this direction is that the macroprudential responsibility and instruments should clearly be transferred to the central bank. Accordingly, it may be considered a step towards the best international practice that the new MNB Act adopted at the end of 2011 granted a macroprudential mandate for the MNB. With this mandate, the Governor of the MNB was authorised to issue decrees on the basis of the decision of the Monetary Council (exclusively in areas not regulated in acts or government decrees), in order to prevent the build-up of systemic risks or to reduce risks. The MNB Act defines the macroprudential decision-making powers covering the following subjects: regulations preventing excessive outflows of loans; liquidity requirements preventing the build-up of systemic liquidity risks; timing, structure and operating conditions of counter-cyclical capital buffers; additional requirements reducing the probability of the bankruptcy of systemically important financial institutions.

3.3 PAYMENT AND SECURITIES SETTLEMENT SYSTEMS

The MNB plays various roles in the payment and securities settlement systems. In support of interbank co-operation, the MNB facilitates the development of payment and securities settlement infrastructure in areas which require the joint decision of payment market participants. As an overseer, the MNB performs regulatory, licensing and supervisory functions in respect of the infrastructure as a whole. As a service provider, it operates the real time gross settlement system (VIBER), in which the final settlements of payments from interbank transactions are performed. Transactions cleared in the Interbank Clearing System (ICS) are settled in VIBER, and in the case of credit institutions settlement of the cash leg of securities transactions of the securities settlement system is also carried out in VIBER. The MNB is the majority owner of the Central Clearing House and Depository Ltd. (KELER Zrt.), co-owner of GIRO Clearing House Limited (GIRO Zrt.) and KELER Central Counterparty Ltd. (KELER KSZF Zrt.) and is a participant in VIBER, ICS and the securities clearing and settlement system.

Steps taken and proposals made regarding cashless payments

The MNB pays particular attention to low-value, basically retail and corporate payments. In the past period, several analyses and studies were prepared with the scope of identifying the characteristics of domestic payments, and in the spring of 2011 the MNB organised a conference entitled *The present and future of the domestic payment system*. A survey of the social costs of different payment instruments revealed that significant social costs savings can be achieved by using electronic payment instruments, and a reduced usage of cash and paper-based solutions.

The usage of payment instruments already follows this trend, but the speed of change is unsatisfactory, and so it is justified to accelerate this process. To achieve the objective, the MNB formulated proposals covering the following subjects:

– Expansion of the scope of financial infrastructure, including the involvement of as many merchants as possible in card acceptance and ensuring the availability of electronic payment services at as many post offices as possible.

– Electronisation of the existing domestic vouchers, processing the related transactions through bank card infrastructure.

– Spreading of electronic billing and payment solutions open for all public utility service providers and consumers and accessible at all payment service providers.

– Representing the costs of postal inpayment money orders to consumers.

– Establishing regulatory control over the scale of interchange fees related to bank card transactions, reducing the percentage of the fee burden at least at a pace complying with the increase in turnover.

– Significant limitation on the role of cash in payments to and from the state.

With regard to the proposals, the MNB initiated discussions with the relevant representatives of the Government and offered co-operation in issues related to payments. As a result, several concrete ideas and amendments to legislation are being elaborated.

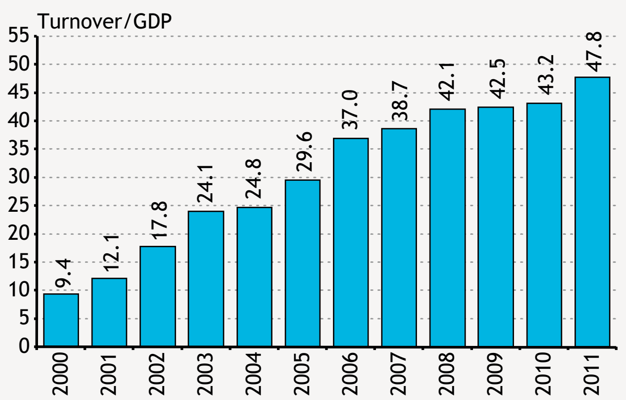
Elaboration of the SEPA (Single Euro Payments Area) regulation – supporting the work of the Hungarian EU presidency

In the first half of 2011, the MNB supported the work of the Hungarian EU presidency by participating in the compilation of the Commission proposal related to the regulation of the European Parliament and of the Council on carrying out euro credit transfers and direct debits in line with a single standard. In close co-operation with the Member States, consulting the European Commission, the Hungarian Presidency formulated a draft text in 6 months, reaching a compromise with qualified majority among the Member States in the EU Council. According to the draft text, which has also been reconciled with the EU Parliament since then, in euro credit transfers and direct debits migration new payment instruments in line with the single standard must take place by 1 February 2014 the latest. Of the elements of the standard, the mandatory use of the international bank account number (IBAN) and of the up-to-date ISO 20022 XML message format are of key importance. The latter is limited to exchanges of messages between payment service providers and clients that initiate or receive direct debits or credit transfers, but are not consumers or micro enterprises. Several transitional provisions help both euro area and non-euro area Member States so that migration can take place within a reasonably short period of time, not only for the items that represent the overwhelming majority of turnover, but also for products satisfying special needs.

Operation and development of VIBER

At the end of 2011, there were 54 VIBER participants. In terms of value, of the total HUF 1,340.6 trillion (thousand billion) turnover of the Interbank Clearing System (ICS), VIBER and the account system of the MNB (hereinafter:

Chart 10
Annual turnover of the ICS, VIBER and Inforex systems as a proportion of GDP

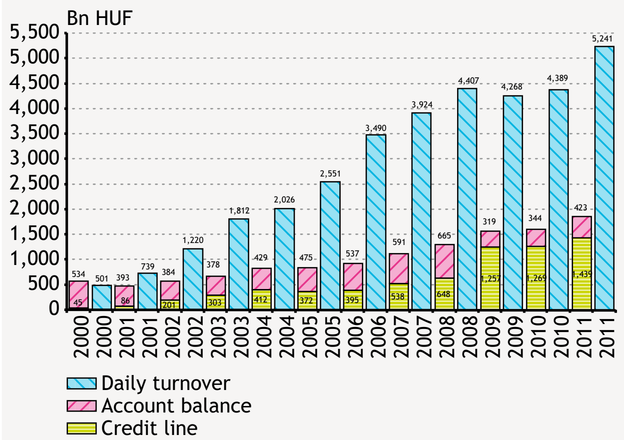


Inforex; the three systems jointly: the systems), 92.98 per cent was settled in VIBER, while ICS accounted for a higher share in the volume of transactions (99.3 per cent). The total turnover of the systems was 47.8 times the gross domestic product (GDP) forecasted for the year.

A total of 1,293 thousand payment transactions in the amount of HUF 1,247 trillion (thousand billion) were settled in VIBER during the year. The value and the volume of transactions increased by 20 per cent and 18 per cent, respectively, relative to the preceding year. The average daily volume of transactions was 5,070, while average daily turnover amounted to HUF 4,888 billion.

The liquidity available for the payments of VIBER participants proved to be enough in 2011 as well. The average daily intraday credit line of the participants – which is provided by the MNB for the purpose of settling payments against pledged securities held as collateral and supplements the current account balance – amounted to HUF 1,439 billion in 2011, exceeding the previous year's figure by 13 per cent. Compared to the previous year, the aggregate average daily balance available on the current accounts of credit institutions increased by 23 per cent and showed an annual average value HUF 423 billion. Total liquidity for settlements – originating from the two aforementioned sources – facilitated the settlement of the combined turnover of VIBER, Inforex and ICS at an average daily value of HUF 5,241 billion, exceeding the average daily turnover recorded in the previous year by 19 per cent. In 2011, the average daily turnover was 2.82 times the average daily liquidity.

Chart 11
Average daily interbank payment turnover and liquidity (account balance and credit line)



Note: The amount of the credit line for 2010 has been adjusted.

Exceeding previous year's figure as well as international expectations, VIBER's availability was 99.955 per cent in 2011.

The MNB carries out an annual revision of the fees charged for the payment services. Compared to the fee in 2010, the fee charged for a VIBER item increased by HUF 170 (to HUF 430) in 2011. As a 2011 development objective, the MNB set it as an aim to introduce the Payment versus Payment (PVP) optional module into VIBER, supporting the risk-free settlement of offsetting large client fund transfers of domestic credit institutions participating in VIBER. The module came online as of 12 December 2011.

The operation and development of ICS

In 2010, in its decree on the execution of payment transactions the MNB set forth a requirement that from 1 July 2012 on domestic electronic transfers would have to reach the payee (its payment service provider) within not more than 4 hours. Based on the decision of the Payment System Council, a nationwide interbank project was launched, which elaborated the detailed rules of the system and co-ordinates the preparations of participants. By the end of 2011, both the development of the central system operating in GIRO Zrt. and the modification of banks' systems were completed, and tests started so that upon being put into service in July 2012 already well-functioning systems that provide trouble-free services ensure the arrival of transfers to the payees even faster than what is set out in the decree.

Oversight of payment and securities settlement systems

In 2011, GIRO Zrt. primarily focused on preparations for intraday clearing. As it is a system still being developed, in terms of oversight the main task was the approval by the MNB of the amendments to terms and conditions that became necessary in the meantime.[4]

Backed by the close co-operation of the designated system operators, i.e. the HFSA, the Ministry of National Economy and the MNB, the specific workstream of renewing the legal framework, procedures and, if necessary, the IT systems as well related to settlement finality requirements initially was launched in connection with the ICS, afterwards gradually spreading over to all the three designated systems overseen. The workstream was launched in due consideration of the lessons drawn from the handling of default events that had taken place earlier. As a result of, inter alia, this working process, Act XXIII of 2003 on Settlement Finality in Payment and Securities Settlement Systems was amended in 2011.[5]

Implementation of the action plan formulated in connection with the comprehensive oversight assessment of the previous year continued in VIBER in 2011. Within this framework, the availability calculation methodology was renewed, which basically meant that the methodology now covers all business functions of VIBER and ensures the monitoring of operational risks that might crystallise in VIBER. Accordingly, on the basis of the business effect visible to VIBER participants, monitoring the service level of VIBER was extended to all VIBER business lines. The new methodology involves practices that are progressive by international standards as well. Methodological improvement of business continuity and intraday interruption tests continued in 2011. VIBER oversight actively participates in formulating the expectations applied in such a test.

Within the framework of the oversight of the securities clearing and settlement system operated by the KELER Group, in 2011 the MNB examined the settlement failure of EMFESZ as the gas market clearing member of KELER KSZF Zrt. and, in connection with the launch of the BÉTa Market, the procedures of KELER KSZF related to settlement discipline. In co-ordination with the oversight, the availability calculation methodology of KELER Zrt. was also renewed. During the year, the KELER Group amended its terms and conditions several times; these rules went through the authorisation procedures of the MNB.[6]

In the first half of 2011, supporting the work of the Hungarian EU presidency, the MNB actively participated in the council stage of discussing the EMIR (European Market Infrastructure Regulation). The fundamental objective of the EMIR is to introduce a mandatory central counterparty clearing requirement in the case of OTC derivative transactions and a reporting obligation with regard to all derivative transactions. In addition, the EMIR entails harmonised European regulation of central counterparties and data warehouses. This regulation (in addition to several other requirements) will also include risk management expectations vis-à-vis central counterparties. Considering that – in the course of the central bank overseeing activity of the KELER Group – emphasis is on risk management procedures, the MNB examined the level of capital of the KELER Group, inter alia, in the light of the EMIR in 2011 (in advance).

[4] http://www.mnb.hu/A_jegybank/kozerdeku_informaciok/tevekenysegre_mukodesre_adatok/teljesitmenyeskapacitas_20100115/az-mnb-gyfelforgalmi-statisztikaja (in Hungarian).
[5] http://english.mnb.hu/Penzforgalom/mnb-as-payment-authority/designating_authority
[6] http://www.mnb.hu/A_jegybank/kozerdeku_informaciok/tevekenysegre_mukodesre_adatok/teljesitmenyeskapacitas_20100115/az-mnb-gyfelforgalmi-statisztikaja (in Hungarian).

Central bank supervisory activity relating to the execution of payment transactions and the prevention of money laundering

By improving legal compliance on the part of payment service providers, payment inspections conducted by the MNB contribute to ensuring more reliable operation of the financial intermediary system and transparent payment processes for customers, thereby strengthening the confidence of customers using the services.

The compilation of the annual audit plan and the identification of the institutions affected[7] in 2011 on the basis of the assessment of the risks of payment transactions and cash processing took place with due regard to the principle that the overwhelming majority of the important participants in payment services and cash processing should be inspected triennially.

During the 2011 payment inspections, the major aspects of inspections included the provisions of MNB Decree No. 18/2009. (VIII. 6.) on the execution of payment transactions (hereinafter: MNB Decree) effective from 1 November 2009 for the purpose of implementing Directive 2007/64/EC on payment services in the internal market (hereinafter: PSD).

Inspections related to the prevention of money laundering covered the following subjects: compliance of internal rules with the relevant act;[8] meeting the customer due diligence and reporting requirements; preserving of specified data and documents; existence and operation of a continuous monitoring and internal control system and the compliance with the regulations concerning training obligations.

On the basis of the experiences of payment inspections, with a few exceptions, each inspected credit institution committed offences that affected the predictability of the performance of payment transactions, and in some cases these offences resulted in material damage as well for their clients (e.g. losses from lost interest). The inspected credit institutions do not fully comply with the provisions of the MNB Decree in spite of the fact that more than two years have elapsed since implementation of the PSD. Some credit institutions still have not carried out the developments required by the changes in legislation that took place in 2009.

The most frequent deficiencies revealed by the payment inspections were found in the following areas:

- acceptance and receipt of payment orders;
- execution of payment orders;
- sending of notifications related to payment orders is inadequate;
- putting in a queue and partial execution of certain uncovered payment orders without an agreement;
- crediting the amount of payment transactions on the account of the payee;
- application of debit value date.

The MNB called upon the institutions concerned to eliminate the deficiencies found during the on-site inspections by a given deadline. Moreover, penalties in a total amount of HUF 21 million were imposed upon[9] 6 credit institutions in connection with the payment inspections.

In 2011, the MNB did not find any deficiencies during the inspections of the compliance with the rules on the prevention of money laundering conducted at cash in transit companies; therefore, the inspections were closed without taking any measures.

Publications

In 2011, the MNB published several studies to facilitate the spread of electronic, cashless payment instruments, which are more cost-effective at the level of society, as well as to familiarise the public with and increase their knowledge of the functioning of payments services in Hungary:[10]

- A survey on the social costs of different payment instruments described the costs of the main domestic payment instruments and quantified the annual savings which could be achieved on the basis of a payment structure applying more up-to-date, electronic solutions.
- In co-operation with the Hungarian Competition Authority, a comprehensive analysis entitled *The role of the interchange fee in card payment systems* was prepared, with the objective of assessing the effect of the interchange fee on the Hungarian market.
- In the analysis entitled *Payment habits of Hungarian households,* the MNB revealed the findings of a

[7] Fifteen credit institutions and saving s cooperatives, the Hungarian Post and 2 cash in transit companies.
[8] Act CXXXVI of 2007 on the Prevention and Combating of Money Laundering and Terrorist Financing.
[9] http://www.mnb.hu/A_jegybank/kozerdeku_informaciok/tevekenysegre_mukodesre_adatok/teljesitmenyeskapacitas_20100115 (in Hungarian).
[10] http://english.mnb.hu/Penzforgalom/publications-pfe

representative survey on the choice of payment instruments by Hungarian households and the relevant motives conducted with the involvement of 1,000 households in 2010.

- In its study entitled *Domestic payments in figures,* the MNB presents domestic low-value payments through its regular data collections.

- The study *Direct debits and factors preventing their spread* analyses the history and function of direct debit in order to explore the possibilities of regulatory or banking community interventions.

- The MNB Bulletin article *On trade vouchers called 'local money'*[11] summarised the most important information on these types of vouchers, which are receiving increasing publicity in the press. In addition, the analysis discussed the risks stemming from the unregulated nature of the voucher market and also formulated regulatory proposals.

In 2011, the MNB prepared a study on the pricing practice applied in the main payment instruments in the payment services of credit institutions and in the indirectly related services, paying special attention to the pricing implications of paper-based and electronic submission channels. The study is scheduled to be published on the website of the MNB in the first half of 2012.

3.4 MANAGEMENT OF FOREIGN EXCHANGE RESERVES

Objectives of holding reserves

Similarly to other central banks, one of the most important tasks of the Magyar Nemzeti Bank, as stipulated in the MNB Act, is the management of the country's foreign exchange reserves. The foreign exchange reserves held by the MNB serve various purposes, the most important of which include:

- to ensure the level of reserves expected by market participants ('international collateral');

- to support monetary policy (ensure intervention capacity);

- to provide foreign exchange required for transactions (support government debt management, satisfy the Government's foreign currency payment obligations etc.).

During the current crisis, market participants have been monitoring development in foreign exchange reserves even more closely than before. The MNB itself regularly reviews the desired level of reserves and, as required and as far as possible, takes measures to ensure the appropriate level. Overall, in the course of 2011 reserves fulfilled the function of 'international collateral'.

One of the guarantees for a predictable, stable exchange rate regime is an adequate level of reserves, which, if necessary, allows for central bank intervention in the interest of protecting the exchange rate. As regards monetary instruments, a sufficient level of foreign exchange reserves and the repurchase facility provided by the ECB were behind the FX swap facilities introduced in recent years in support of the foreign exchange liquidity of the banking system.

In terms of transaction goals, servicing the management of government debt continued to be the most important objective last year. In this regard, the continuous provision of the foreign currency needs of budgetary organisations should also be considered. Transfers from the European Union are also received through the MNB. These transfers have been significant sources for the accumulation of reserves in recent years – and will continue to be in years to come. In the course of 2011, these transaction goals were once again accomplished smoothly.

The MNB still does not intend to maintain reserves solely for the purpose of accumulating wealth. At the same time, however, it strives to meet total return criteria when managing foreign exchange reserves in the required amount at all times, i.e. as a responsible asset manager, it intends to preserve their value and, as far as possible, attain an extra return.

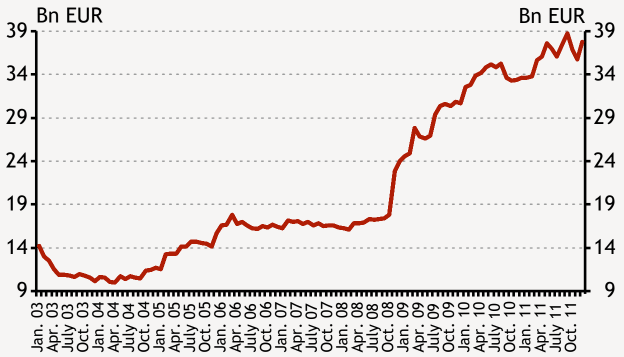
Amount of reserves

With an increase of EUR 4.1 billion during the year, the official foreign exchange reserves amounted to EUR 37.8 billion at the end of 2011. The increase was primarily due to transfers amounting to EUR 4.3 billion received from the European Union; the other, mainly debt management related flows broadly offset one another. Of the debt management items, the bonds issued with a face value of USD 4.25 billion and EUR 1 billion by the Hungarian Government contributed to the increase in reserves in the first half of the year. Other debt management related items

[11] http://english.mnb.hu/Root/Dokumentumtar/ENMNB/Kiadvanyok/mnben_mnbszemle/mnben_mnb_bulletin_april_2011/helmeczi-koczan_ENG.pdf

of the Government Debt Management Agency (ÁKK) (sale of private pension fund assets, mark-to-market account movements, etc.) resulted in a net increase of EUR 1 billion. Own return on foreign exchange reserves amounted to nearly EUR 0.9 billion. The rise in the sum total of short covered deposits related to the end of the year resulted in an increase of approximately EUR 0.8 billion. On the other side, a decline in reserves resulted from bonds with a total face value of EUR 2 billion maturing during the year, and a loan of EUR 2 billion was repaid to the European Commission in the last quarter. Payments related to the MNB's own debt servicing amounted to EUR 225 million. In addition, disbursements in foreign currency commissioned by budgetary institutions reduced the reserves by a total amount of around EUR 2.1 billion, which was primarily attributable to the purchase of MOL shares. The foreign exchange tenders related to the early repayment scheme of FX mortgages resulted in a total outflow of EUR 862 million in the last quarter of 2011.

Chart 12
Developments in foreign exchange reserves



The MNB's financial risk management

Inevitably, the MNB faces financial risks in carrying out its basic statutory tasks. As a general principle, the degree of risks assumed should be obvious and visible, risk assumption should be purposeful, and the magnitude of risks taken should be consistent with the objectives of the basic tasks. The MNB applies limits to mitigate financial risks related to the management of foreign exchange reserves. In line with the conservative reserve policy typical of central banks, during its reserve management the MNB applies a strict limit system, which takes account of other market indicators as well, in addition to the required high-level credit ratings.

Determining the framework of risk-taking falls within the powers of the Monetary Council. Accordingly, it takes decisions on the fundamental principles of reserve and risk management, the degree of market, liquidity and credit risks of portfolios and the benchmark policy, and establishes strategic benchmarks as well as specifying the currencies of the reserve portfolios.

Within the framework defined by the Monetary Council, the limit system is approved by the Chairman of the MNB's Implementation Committee, including the maximum acceptable deviations of the risks affecting the reserve portfolios vis-à-vis the benchmarks, counterparty limits and the range of investment instruments accepted for the purpose of reserve management. Throughout the year, the Asset-Liability Committee (ALCO) reviewed market developments and monitored the Bank's risk exposure on a monthly basis.

The two main pillars of the risk management policy are the two-tier benchmark system and the limit system attached to the benchmarks. In order to measure the success of portfolio management, the performance of each reserve portfolio is compared to that of a reference portfolio (so-called benchmark portfolio). Benchmark portfolios show what yield would have been produced by a passively managed portfolio that represents a wide market segment if investment parameters had been the same. The performance of the foreign exchange management activity is reported in the context of these reference portfolios. The benchmarks – reflecting the return/risk preference of the MNB and measuring the performance of the portfolios – are maintained by the risk management institutional unit, a unit independent of the business area.

In 2011, the MNB managed the foreign exchange reserves in euro and US dollar portfolios. However, it undertook exchange rate exposure only in euro, covering the risk of the dollar/euro cross rate by derivative instruments. Holding dollar assets with exchange rate coverage is justified by two objectives: to achieve a higher level of diversification on the one hand, and to provide dollar liquidity on the other hand. The MNB actively manages a total of five portfolios denominated in the two currencies, with each portfolio based on a different strategy. In euro, it holds a so-called credit risk free portfolio and an investment portfolio in addition to the money market portfolio, whereas in dollars it holds a money market portfolio and an investment portfolio.

The credit risk free euro portfolio, which constitutes the majority of the foreign exchange reserves, exclusively consists of high-rated government papers (securities guaranteed by high rated states) and the issuances of supranational institutions, and its benchmark only includes government securities of EMU member countries with an AAA credit rating. In addition to the above, the euro investment portfolio can only include high-rated corporate and bank issuances as well as collateralised securities; if this portfolio contains government securities, it is typically for liquidity management purposes. Accordingly, the benchmark of the investment portfolio is representative of the performance of a broad range of euro-denominated market issuances with a high credit rating. Owing to its size, the dollar investment portfolio has not been separated; therefore, its performance reflects the yields of dollar-denominated government securities and – similarly to the credit risk carrying securities managed in the euro investment portfolio – high-rated dollar-denominated bonds.

Chart 13
Structure of the overall euro-denominated benchmark portfolio

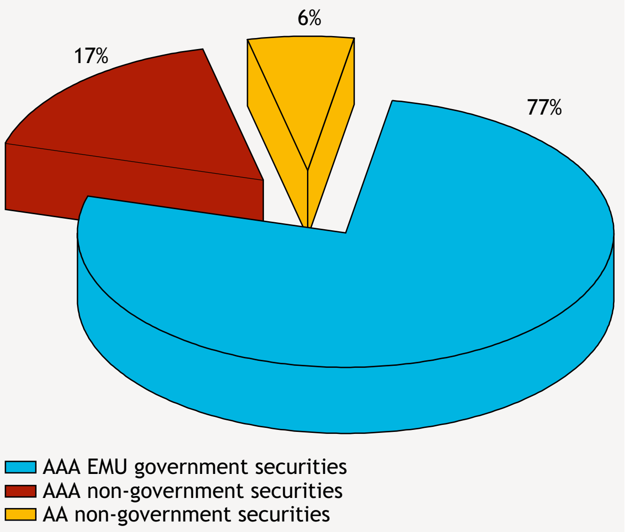
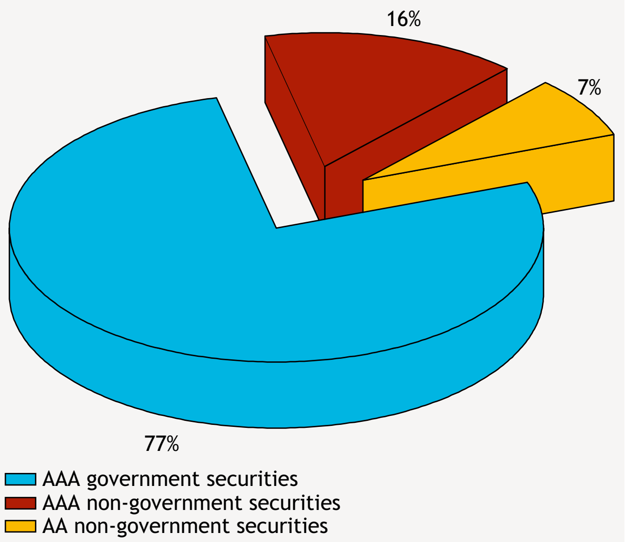


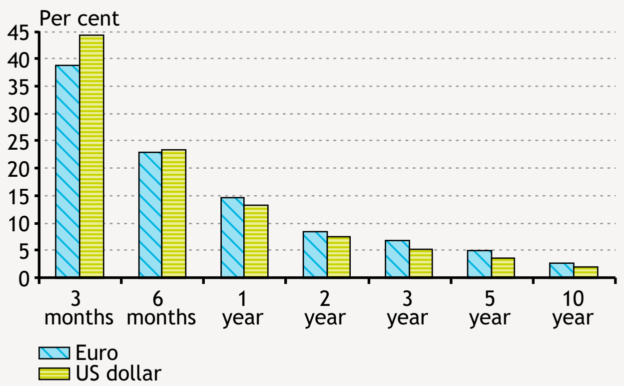
Chart 14
Composition of the dollar-denominated investment benchmark portfolio based on credit rating



The benchmark of both the euro- and the dollar-denominated investment portfolios contains high-rated government securities, corporate and bank bonds as well as money and capital market assets with a maximum remaining maturity of 10.5 years. The composition of the benchmark portfolios according to the credit ratings of assets and remaining maturity reflects the conservative risk appetite typical of central banks.

On 31 December 2011, 100 per cent of the credit risk free euro-denominated benchmark portfolio consisted of AAA-rated government securities of the European Economic and Monetary Union (EMU government securities). 77 per cent of the total euro-denominated benchmark portfolio consisted of AAA-rated EMU government securities, whereas AAA-rated and AA-rated other securities accounted for 17 per cent and 6 per cent, respectively. Similarly, AAA-rated government securities accounted for 77 per cent, AAA-rated other securities for 16 per cent and AA-rated other securities for 7 per cent of the dollar-denominated investment portfolio.

Chart 15
Composition of the dollar-denominated and the (combined) euro-denominated investment benchmark portfolios based on residual maturity at end-2011



As the return on the reserves primarily depends on the market performance of the specific investment asset class, its size only partly reflects the actual effectiveness of active reserve management.

Both in absolute terms and relative to the comparable benchmarks, the Bank performed well in 2011 with respect to foreign exchange reserves. The liquidity required for the achievement of monetary policy objectives was available throughout the year, with no credit event adversely affecting the reputation of the MNB. The good performance of the reserves was mainly a result of the positive revaluation originating from the decline in yield of the government securities that have the highest credit rating and constitute the majority of the reserves. Exceeding the 2.53 per cent yield on the benchmark portfolio by 37 basis points, the annualised performance of the so-called credit risk free portfolio was 2.90 per cent. The euro-denominated investment portfolio yielded an annualised return of 2.60 per cent, 19 basis points above its benchmark. The annualised yield on the dollar-denominated investment portfolio – adjusted by the cost of the exchange rate hedging – exceeded its benchmark by 94 basis points and stood at 3.04 per cent. The annual return of 1.28 per cent on the euro-denominated money market portfolio exceeded the relevant benchmark by 52 basis points, while that on the dollar-denominated money market portfolio amounted to 0.45 per cent, also outperforming the 0.14 per cent result of the benchmark by 31 basis points. Exceeding the 2.48 per cent return on the weighted benchmark by 34 basis points, the annual return on the portfolios weighted with market value amounted to 2.82 per cent.

For most of the period, the strategic target duration of the investment portfolios was 1.5 years. A 58 basis point fall in the yields of euro-denominated government securities with corresponding duration was observed, which contributed to the good performance of both the benchmark and the portfolio in the credit risk free segment. Yields on dollar-denominated government securities also declined: for the relevant 1.5 years they were nearly 10 basis points below the level one year earlier. The relatively high absolute performance of the investment portfolios can be partly attributed to the downward shift in the yield curve as well as the selection of securities and their allocation among countries by the portfolio management.

Similarly to the previous year, the environment of foreign exchange reserve management was strongly influenced by the impact of the credit crisis on European sovereign issuers. While the sovereign debt crisis of euro area periphery countries resulted in a significant and prolonged increase in the credit risk premia of these countries, as a result of flight to quality, the securities of higher-rated issuers, which constitute the majority of the foreign exchange reserves of Hungary, appreciated. The Bank reacted to the European sovereign crisis by further tightening of investment principles, by making the structure of benchmarks more conservative and by further tightening of the limits differentiated according to the remaining maturity of the investments and based on credit rating and other market indicators.

Concerning the future, it poses a risk that the yield level of the highest-quality euro area issues is at an unprecedented low, and consequently the interest yield attainable on the reserve is very low, while a possible yield increase may cause revaluation losses via depreciation of existing bonds. In order to reduce this risk, the Monetary Council decided to shorten the 1.5-year strategic target duration by half a year.

The value-at-risk of the items in the MNB's foreign exchange balance corresponding to the changes in the interest rate amounted to EUR 71 million at the end of the year (95 per cent confidence level VaR over a one-month time horizon). The average daily foreign exchange risk calculated for 2011 amounted to EUR 11,992 (1-day VaR with a 95 per cent confidence level). The values reflect the implementation of the conservative guiding principles laid down in the risk-taking policy.

Managing operational risks

In the deteriorating external market environment resulting from the protraction of the international financial crisis to 2011 as well and in the rapidly changing domestic regulatory environment, cost-effective management of operational risks remained a task of primary importance. The standard of preparedness for risks had to be maintained even under increasingly difficult circumstances.

The Bank placed great emphasis on supplying its employees with the most thorough knowledge possible – at practical level as well – concerning the rules contributing to the safety and security of operations and employees. A summary document of the most important rules applying to all employees was prepared, and during the year – in a comprehensive test – each employee had to give account of how to act and take decisions regularly in a given real situation.

The changing of the recording of classified data, which started in 2010, continued in line with statutory regulations; protection of classified data was facilitated by the changing of working processes and IT developments.

The 'operational risk manual', which describes the principles and rules of operational risk management, was renewed and substantially augmented with parts regulating the tasks to be performed when preparing for crisis situations and the relevant system of responsibility. One of the key elements of the preparations for crisis situations is practicing the evacuation of buildings. Therefore, in 2011, the MNB carried out an evacuation exercise that was not pre-announced. The exercise was directed by the Security organisational unit, and was completed successfully.

A structured registration and analysis of events and incidents with minor effects taking place in the course of the operation of the Bank provide important information for a reasonable assessment of operational risks. These events may highlight the vulnerability of banking processes and the risk exposure of their values, allowing timely and more successful preparations in order to avoid more serious losses. Some organisational units have been collecting data on events for several years. Utilising the experiences of earlier years as well, this practice became general in the work of the Bank as a whole in 2011.

The MNB has to credibly prove that even in emergencies it is able to attend to its basic tasks and in particular to maintain the smooth operation of the domestic payment system as well as to ensure the supply of the population with cash. Therefore, with the involvement of external participants, the MNB conducted three business continuity tests in 2011.

3.5 CASH LOGISTICS ACTIVITIES

Currency in circulation

The increase in the value of currency in circulation that started in 2010 continued at an accelerated pace in 2011 as well. On 31 December 2011, the value of banknotes and coins in circulation amounted to HUF 2,693 billion, up by 14 per cent, i.e. HUF 332 billion, compared to the end of the previous year. The increase accelerated in the second half of last year, which may presumably be explained by the fact that for the time being households reserve a portion of the pension fund real yield cash disbursements in cash. In addition, households' euro cash sales (due to the stronger exchange rate of the euro) may also have added to forints in circulation, and the early repayment of foreign exchange based loans may also have contributed to the increase in currency in circulation.

Chart 16
Value of currency in circulation
(end-of-month figures, seasonally adjusted)

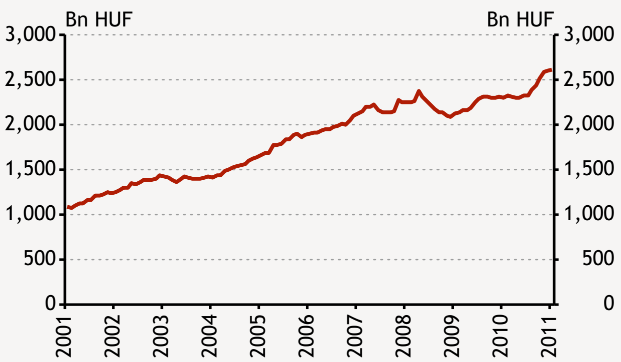
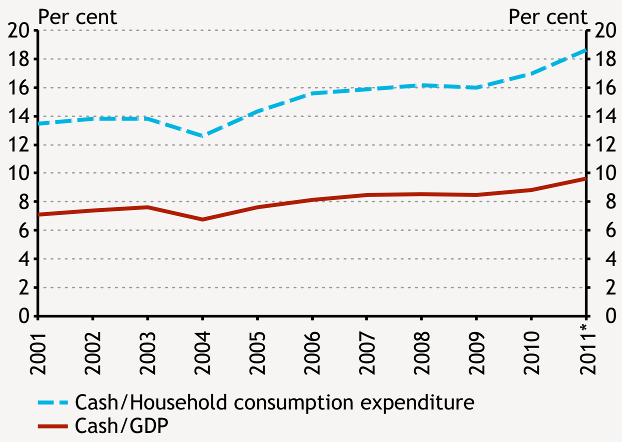


Chart 17
Cash/GDP and cash/household consumption expenditure



** The 2011 GDP data and the data of household consumption expenditure are MNB estimates.*

By the end of 2011, the amount of currency in circulation as a proportion of GDP, which had already been high before, reached an all-time high, and the value of cash in circulation grew at an even faster pace than households' consumption expenditure.

High denominations continued to dominate in the increase in cash in circulation. In 2011 – in terms of volume – the share of 20,000 forint banknotes within all denominations increased by 2 percentage points, while the share of banknote denominations intensively used in everyday shopping transactions declined or stagnated. This is presumably related to the further strengthening of wealth accumulation in cash. At the end of 2011, the two highest denominations accounted for some 58 per cent of the total

Chart 18
Breakdown of banknotes in circulation by their number as at end-2011

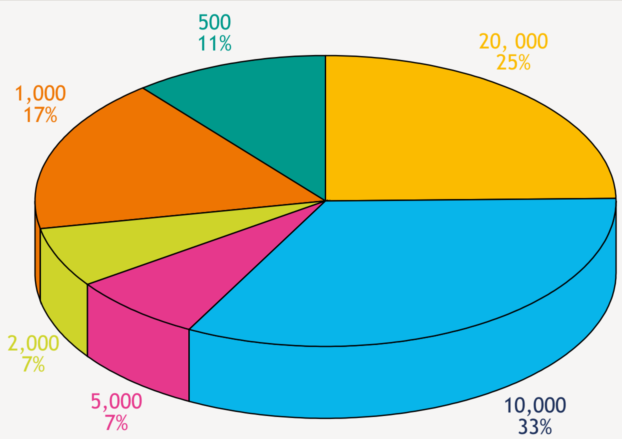


Table 2
Quantity and value of banknotes and coins in circulation on 31 December 2011

Banknotes	Volume (Million pieces)	Value (Billion HUF)	Ratio (%)	
			Volume	Value
20,000 forint	72.4	1,448.9	24.6	54.9
10,000 forint	97.4	974.2	33.1	36.9
5,000 forint	22.1	110.3	7.5	4.2
2,000 forint	19.6	39.3	6.6	1.5
1,000 forint	51.0	51.0	17.3	1.9
500 forint	32.1	16.0	10.9	0.6
Sum	**294.6**	**2,639.7**	**100.0**	**100.0**
Coins	**Volume** (Million pieces)	**Value** (Billion HUF)	**Ratio (%)**	
			Volume	**Value**
200 forint	88.9	17.8	7.2	37.9
100 forint	143.4	14.3	11.7	30.5
50 forint	116.1	5.8	9.5	12.4
20 forint	218.4	4.4	17.8	9.3
10 forint	261.9	2.6	21.3	5.6
5 forint	398.9	2.0	32.5	4.3
Sum	**1,227.6**	**46.9**	**100.0**	**100.0**

Note: The table does not contain the commemorative coins issued by the Bank; at par value these coins are legal tender.

number of banknotes in circulation. The high ratio of cash intensity, in particular the ratio of higher denominations (primarily 20,000 forint banknotes), is strengthened by the lack of trust among enterprises, in addition to the cash demand of the hidden economy. Moreover, the state also contributes to it, for example with its customary terms of payment provided and applied upon the collection of taxes and contributions and the disbursement of social transfers. In order to narrow the room for manoeuvre of the hidden economy and to reduce the excessive use of cash, the strengthening of solutions allowing electronic payment would be important in all the sectors concerned.

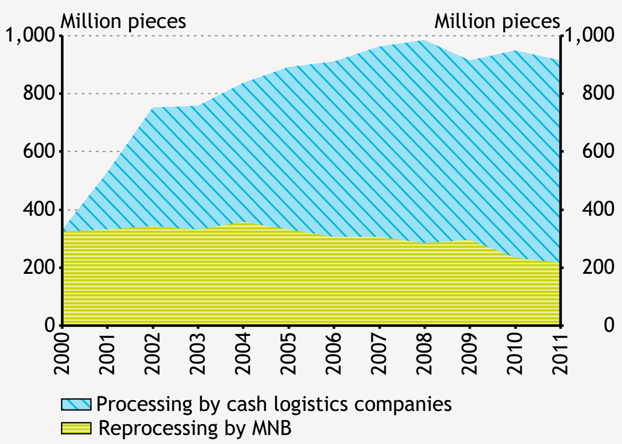
Cash distribution

The MNB participates in the domestic cash supply chain as a wholesale distributor. Banknotes and coins reach end users through the customers of the MNB, i.e. credit institutions and the Hungarian Post. By establishing a limited notes-held-to-order scheme for credit institutions and the Hungarian Post and by motivating banknote and coin trading between credit institutions, the Bank took further steps to strengthen its wholesale service provider role.

In the checking of banknotes and the circulation of fit banknotes the MNB is participating in an increasingly indirect manner, playing an increasingly regulatory role. With the introduction of transaction fees and stricter logistics standards as well as the gradual reduction of its country network (and its liquidation by 2008) the Bank achieved that market participants (credit institutions, the Hungarian Post and the professional cash logistics companies that provide services for them) properly carry out the quality checking of banknotes and recycle the ones fit for circulation within market circles, increasingly avoiding the Central Bank. The essence of the functioning of the cash cycle is that first the banknotes are checked by market cash logistics service provider companies,

Chart 19
Banknote processing (MNB and cash logistics companies) at an annual level

(estimated processing data for 2000–2002)



which recycle the necessary amount to the market. Banknotes not needed for the daily operations of banks flow into the MNB for reprocessing and storing. Today, cash logistics companies process and recycle into the economy around the quadruple of the banknote amount processed by the Central Bank. The authenticity and fitness checking of banknotes recycled into the cash circulation by cash logistics firms is regulated in an MNB decree and regularly inspected by the MNB.

Since 1 January 2011, within a contractual relationship the MNB allows larger credit institutions and the Hungarian Post to hold so-called notes held to order, i.e. cash owned by the MNB, in their depositories. The objective of the introduction of the NHTO scheme was to facilitate the flow of banknotes between the Bank engaged in wholesale logistics and the credit institutions and the Hungarian Post, which employ smaller logistical (packaging) units. The MNB limited the maximum amount of the NHTO; as a result, the amount of the NHTO remains below one per cent of all banknotes in circulation. The NHTO scheme facilitates compliance with central bank logistics standards and contributes to a reduction in banknote transportation. In 2011, the system functioned in line with the pre-determined rules in each case. For a further strengthening of wholesale logistics, the Bank continues to develop the rules of the NHTO scheme in 2012.

In the past years, the MNB made great efforts to modernise coin distribution, to increase the efficiency of coin logistics and to develop coin trading among banks, the Hungarian Post and cash logistics service providers. The key means of the change was the system of central bank coin stocks (coin depo) held by cash logistics service providers (Coin Held to Order Scheme). The relevant objective was to narrow the MNB's buffer role in daily coin distribution to the minimum: the MNB should only make up for the amount of coins lost in circulation or excluded from circulation due to hoarding and put into circulation an amount of coins that complies with the need of an increase in circulation, and should only accept the return of those coins from circulation that have been redundant permanently (for at least half a year). As a result of the project, at the national economy level the transportation of coins declined by an annual quantity of around 1,000 tons by 2011, which is primarily attributable to the daily transactions that avoid the MNB.

In 2011, the MNB handled cash turnover in an amount of HUF 3,087 billion within the MNB provided 248 million banknotes to its clients, meanwhile, credit institutions and the Hungarian Post had 217 million banknotes delivered to the Bank.

In 2011, the Bank qualified 25 per cent of the banknotes it processed (i.e. approximately 62 million banknotes) as unfit for circulation and replaced them with new, good-quality banknotes.

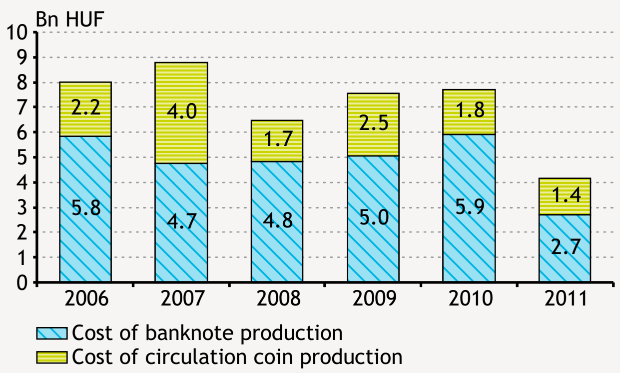
Banknote and coin production

In order to meet an increasingly large cash demand and replace unfit and therefore destroyed banknotes and coins, the Bank has banknotes and coins produced.

In 2011, the cost of cash production was a gross amount of HUF 4.1 billion, which is 47 per cent less than in the previous year. Between 2008 and 2011, the Bank took a number of cash-related strategic measures that may result in total savings of tens of billions of forints over the longer term. The remarkable decline in production costs, which are expected to remain at lower levels than earlier, is explained by the decisions related to the denomination structure (the withdrawal of the 1- and 2-forint coins as well as the replacement of the 200-forint banknotes with coins), the rationalisation of production and the efficient inventory management.

Chart 20
Production of banknotes and coins in circulation

(gross cost)



In 2011, the average cost of production of one banknote was approximately gross HUF 52 and that of one coin amounted to gross HUF 48.

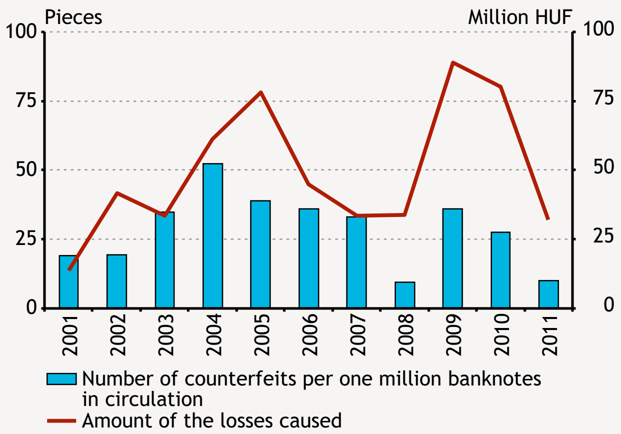
Prevention and reduction of counterfeiting

In 2011, the number of counterfeit forint banknotes withdrawn from circulation was 2,972, representing a nearly 60 per cent decline compared to 2010. Relative to the previous year, the amount of direct losses caused by counterfeits declined significantly, also by 60 per cent. The decline observed in the number of counterfeits is also

Table 3
Discovered counterfeit HUF banknotes in a breakdown by denominations in 2011

Denominations	500	1,000	2,000	5,000	10,000	20,000
Breakdown (%)	7.0	0.5	3.0	15.0	49.5	25.0

Chart 21
Developments in the number of counterfeits per one million genuine banknotes and the amount of losses caused



reflected in the number of counterfeits per one million genuine banknotes per year; following the outliers of previous years, by 2011 this number fell considerably, i.e. to 10, which is a value that by now can be considered an average among the national currencies similar to the forint.

After 2010, higher-value banknote denominations were also dominant in counterfeiting last year; the 10,000 and 20,000 forint banknotes accounted for 74.5 per cent of all discovered counterfeits.

Although their number declined, the sometimes deceiving quality of large denomination counterfeit banknotes directs attention to the importance of checking, as these counterfeits can be detected using appropriate devices (e.g. UV-A/C lamps) or by simple human examination (e.g. touching, holding against the light or tilting the banknote).

Apart from a small number of counterfeits prepared using typographic methods, forint counterfeits were typically produced with office reproduction equipment, photocopiers and printers.

The favourable developments in counterfeiting data prompted the Bank to focus on prevention and preparations, in line with one of its main cash strategy objectives, and to call the attention of all stakeholders to it.

In 2011, the Bank reinforced its support for the activity of cashiers in the retail sector, who play a key role in the detection of counterfeits. Accordingly, last year the spread of banknote related knowledge played a prominent role. At free on-site trainings, MNB experts prepared thousands of cashiers (of both credit institutions and retail outlets) for the most up-to-date methods of banknote checking.

The MNB's initiative launched in 2011 also supported the activity of cashiers working in trade, namely the more wide-spread use of a state-of-the-art cashier's method, i.e. the application of the combined lamp (which contains both UV-A and UV-C tubes). Through the tender announced by the MNB for retail shops, applicants could buy the combined UV-A and UV-C devices with significant financial support granted by the Central Bank. The result of the programme is that in 2011 the sales of UV-A/C devices increased by more than 50 per cent (compared to 2010) within the aggregate sales of distributors that joined the programme of the MNB. To further strengthen protection against counterfeits, the MNB is planning to repeat the successful support programme in 2012.

As a result of the renewal of the website of the MNB, a richer choice of banknote-related information has become available, while professional cash processing organisations may download instructional materials and guidelines that may prove useful in the everyday practice of cashiers.

The experts of the MNB examined a total of 1,327 currency counterfeits in 2011. Overall, the number of counterfeit euro banknotes found remains insignificant. Last year, a total of 995 counterfeits were examined and withdrawn from circulation; most of them were 20, 50 and 100 euro banknotes.

Regulatory changes

The MNB revised the MNB decrees on the tasks related to the distribution, processing and protection against counterfeiting of banknotes and coins. Within the framework of this activity, in addition to making the modifications justified by experience related to the application of the statutory regulations, new requirements were also included in the decrees. The new legislation, MNB Decree No. 11/2011 (IX. 6.) and MNB Decree No. 12/2011 (IX. 6.), entered into force on 1 November 2011, although different dates of entry into force were established for certain provisions.

The new regulation entails a material change for the key cash market participants (credit institutions, the Hungarian Post and cash processing organisations) mainly as a result of the widening of the mandatory scope of application of the banknote handling machines successfully tested by the MNB. With the introduction of the new rules the MNB aims to increase the protection of forint banknotes against counterfeiting and improve the adequate quality of forint banknotes in circulation. In order to increase the security of cash supply, the regulations also included requirements for the assessment and management of the operational risks involved in cash distribution. In addition, the MNB places strong emphasis on compliance with the denomination exchange obligation of credit institutions and the Hungarian Post, and therefore, it adopted regulations on customer information aimed at the protection of the interest of clients.

Issue of commemorative coins

In 2011, the MNB issued three gold, six silver and one cupronickel commemorative coins.

On 11 January 2011, the birthday of Ányos Jedlik, the MNB issued a cupronickel commemorative coin with a face value of HUF 1,000, marking the 150th anniversary of the description of the dynamo principle. In the first half of 2011, Hungary held the rotating presidency of the Council of the European Union; in commemoration of this, on 12 January the MNB issued a silver commemorative coin entitled 'Hungarian Presidency of the Council of the European Union' with a face value of HUF 3,000. Covering the subject of the EU presidency, a 2011 circulation coin series was also issued.

In March, the MNB issued a silver commemorative coin named 'Mohácsi busójárás' with a face value of HUF 5,000 to commemorate the admission of the tradition of the Busó walk in Mohács to the UNESCO's Representative List of the Intangible Cultural Heritage of Humanity in the autumn of 2009. The Busó festivities, which drive the winter away and welcome the spring, are the first item from Hungary on the list.

Several series continued in 2011. The Bank issued various silver collector coins with a face value of HUF 5,000 each: one to commemorate the 125th anniversary of Árpád Tóth's birth, in the series presenting Hungarian writers and poets; one about the Danube-Drava National Park, as the second member of the series presenting national parks; and one to commemorate the 200th anniversary of the consecration of the Evangelical Church on Deák Square, as the last piece in the series presenting the masterpieces of church architecture.

The MNB commemorated the 100th anniversary of the birth of István Bibó, the greatest democratic political thinker of the 20th century, with a silver collector coin with a face value of HUF 5,000 and the 200th anniversary of the birth of Adam Clark, the builder of the Chain Bridge and the architect of the Tunnel under the Buda Castle, with a gold commemorative coin with a face value of HUF 5,000.

The year was closed with a real speciality, a gold collector coin with a face value of HUF 50,000 to commemorate the 200th anniversary of Ferenc Liszt's birth on 22 October. In addition to the 'traditional', 2-ducat weight, a double-weight, so-called piefort version was also issued.

In the Coin of the Year competition announced for the fifth time by Krause Publications, with 75 per cent of the votes again a Hungarian coin proved to be the most popular: a silver collector coin 'Őrség National Park', designed by the sculptor Gábor Gáti and made in 2010 with a face value of HUF 5,000. The award is a symbol of the expression of national pride, and also serves the support of the coin-making art of the issuing country.

3.6 STATISTICAL SERVICES

Based on the powers vested in it by the MNB Act, in order to carry out its fundamental duties, including, inter alia, the analysis of financial trends, the preparation of monetary decisions, ensuring smooth money circulation, the oversight of the operation of payment and settlement systems as well as support for the stability of the financial system, the Bank collected statistical data (not qualifying as personal data) and published statistics compiled on the basis of such data in 2011 as well.

The MNB prepares and publishes monetary, balance of payments, financial accounts and securities statistics as well as time series on prices, exchange rate statistics and money and capital markets on its website according to a publication calendar disclosed to the public. The Bank also publishes methodological documents related to the individual statistical areas.

Based on MNB Decree no. 19/2010. (XII. 10.) on data reporting in respect of 2011 as a reporting period, intra-year data reporting was also ordered in connection of the early final repayment of FX loans. Act CXXI of 2011 on the modification of certain statutory regulations regarding the protection of family homes allowed debtors with contracts for FX-based loans meeting the criteria laid down in the applicable legislation to repay their debt at a fixed exchange rate that was lower than the prevailing market rate. Given the importance of the impact of the early final repayment scheme on credit institutions and the fact that certain data were needed for the use of a monetary policy instrument (MNB tendering procedures for euro sales) engineered to respond to the early final repayment scheme, through issuing MNB Decree no. 13/2011. (X. 3.), the MNB ordered that further data be reported and accorded high priority to the investigation into the quality of these data within the framework of its policy to check on the quality of statistical data on an ongoing basis.

Harmonisation between the different statistical areas, new publications and preparation for methodological changes

In 2011, the continuation of harmonisation played a key role in the MNB's statistical activity, aimed at the alignment of Central Statistical Office (CSO) and MNB statistics and reduction in the differences between the MNB's own statistical products.

The difference between balance of payments statistics and financial accounts statistics has been reduced to a minimum in the relevant publications. The extent of and the underlying reasons for the differences that have still remained are disclosed quarterly, concurrently with the publication of a press release on comprehensive financial accounts.

Concerning repurchase-type transactions, the MNB revised its balance of payments, financial accounts, securities and monetary statistics, as a result of which repo transactions and securities lending transactions are recorded consistently and in accordance with international statistical methodologies in all the relevant statistics.

The MNB worked in close co-operation with the experts of the CSO and the Ministry of the National Economy (MNE) in compiling the report on excessive government deficit and debt (Excessive Deficit Procedure, EDP report) for the European Commission. As a result of problem-solving discussions, the extent of statistical discrepancies in the EDP reports (i.e. the differences between the general government net lending stated in financial accounts and the one stated in non-financial accounts) declined significantly in respect of earlier data as well. The MNB and Eurostat managed to resolve the methodological issue of the way in which the state's funding the central bank's revaluation reserve must be recognised.

The MNB made several new publications available at its website in 2011. The Statistical Department started to publish the balance sheet and the key data of the profit and loss accounts of large corporations in central and local government ownership in order to provide information on the financial indicators of these companies (their debts and net lending).

The Statistics Department also discloses the composition of household loans on a quarterly basis. The data collected for the purpose of this disclosure were subjected to a data quality check retrospectively as far back as 2009, with the data collected by the HFSA also utilised.

Data on securities are now disclosed monthly compared with an earlier quarterly basis, and the data now published are also more detailed. The new disclosure provides a comprehensive picture, on both the holder's side and the issuer's side, of the stock and transaction data of the securities issued by residents.

In 2011, work continued on the revision of the European methodological standards regulating the compiling of national accounts and the related statistics *(SNA 2008, ESA 2010, OECD BD4 applicable to foreign direct investments with effect from 2009 and the new balance of payments methodology BPM6)* and their adoption, as well as the preparation of the modification of the related regulations at European level legislation in the issues that have been already finalised. The new standards of national accounts and balance of payments are to be adopted from 2014. The MNB and CSO have been working in close cooperation based on a joint time schedule to prepare the introduction of the standards.

After several years of preparation, a working group related to the modelling of the implicit pension debt of the social security system was set up in 2011. Members of the working group also include CSO and MNE staff members. The MNB and University of Freiburg concluded an agreement, under the aegis of which, in December an expert from Germany presented the operation of the pension model developed by the University.

An in-depth analysis of the finalised methodological changes was conducted during the year, of which detailed list was drawn up. Each item of information in connection with the changes (the content and nature of as well as the IT systems and decision points affected by the changes) was recorded separately. Based on the detailed list of tasks compiled by institutions, joint MNB-CSO working groups were formed to investigate the methodological and technical issues which might emerge and to work out alternative decisions.

Improvement of data quality and system development

An updated, supported version assisting the technological basis for the electronic data reception (EBEAD) system was provided in 2011. As a result, data input is now faster and more secure. The registries of the EBEAD system were upgraded in a manner that enables the MNB to rely on its own internal resources in checking consistency, allowing developer intervention to be reduced. The treatment of repo transactions in the various specialised statistics was aligned in both statistical processing and in the EBEAD system.

In 2011, the MNB expanded the content of the data assets of its data warehouse in respect of certain types of data (e.g. payment transaction data) and the number of the users also rose. Furthermore, in line with the ever changing needs of analysts, daily uploading of certain data was replaced with intra-day uploading (even several times a day); as a result, the Bank was able to attend to its tasks related to the early final repayment scheme, the overlay (separate suspense) account scheme and liquidity.

International data reporting and co-operation

The MNB complied with all of the reporting obligations pertaining to EU Member States in 2011. Accordingly, it regularly provided data to the statistical office of the European Union (Eurostat), the European Central Bank and the Bank for International Settlements (BIS). In accordance with its status as a central bank, and in keeping with the expectations arising from international cooperation as well as its membership obligations, the MNB provides data and information on a regular basis to the International Monetary Fund (IMF), the World Bank and the Organisation for Economic Co-operation and Development (OECD). The MNB played an active role in international statistical working groups in 2011 as well.

3.7 PRACTICAL PREPARATIONS FOR EURO CHANGEOVER

The National Euro Co-ordination Committee (NEC) was established by the Government Decree 1071/2007. (IX. 21.) in September 2007. In order to better reflect the new government structure, and also because of the uncertainty surrounding the expected date of the euro changeover and its impact on the scheduling of the related tasks, the amendment of the above Government Decree was initiated by Government Decree No. 1296/2010 in December 2010. Since the Governor of the MNB is also the co-chair of the NEC, the MNB plays a key role in identifying the preparatory tasks associated with euro adoption in Hungary. Determination of these practical tasks can be carried out even without setting the eventual target date for the introduction of the euro; and the practical preparation can be launched, even in the absence of a valid target date.

It is clear, however, that the financial crisis and its consequences have somewhat postponed the possibility of setting a target date for the adoption of the euro. Based on the recent experience of a number of countries of the Eurozone, it is evident that numerically meeting the convergence criteria (the so-called Maastricht criteria) is not sufficient to create the conditions for adoption of the euro. In addition to complying with the economic conditions, the definition of the system of the practical, logistical, IT and legal requirements associated with the euro changeover also constitutes an important precondition.

Given the complexity of this task, determining and starting the practical preparations at a stage when the macroeconomic criteria will have already been met is far too late, as it may lead to further undesirable delays in the adoption of the euro.

The major responsibilities of the committee in charge of managing the national preparations (NEC) are as follows:

- In close cooperation with all relevant parties, it prepares the National Changeover Plan (NCP) which is necessary for the introduction of the euro, as it outlines the tasks of the financial, corporate and public sectors, those of the legal and IT systems, also specifies certain duties related to consumer protection, accounting and statistics, and draws up the planned timeline associated with the changeover process. The NEC reviews the NCP as needed and monitors its implementation.

- Through the issuance of professional recommendations related to IT, price displays, accounting systems, currency exchange and cash changeover practices, the NEC actively supports the preparation of the public and private sectors for the adoption of the euro.

- It provides information to the public in relation to the individual preparatory phases of euro changeover through efficient communication methods.

- It puts forward proposals with respect to the development of the legal framework for changeover and initiates the necessary legislation.

Moreover, the preparation for the introduction of the euro has also been recognised as an issue of special significance in the 2007–2013 medium-term strategy of the MNB:

– 'In the course of preparations for the adoption of the euro, the MNB plays a role on the one hand in analysing and monitoring the macroeconomic conditions for changeover and in supporting its macroeconomic foundation, and on the other hand in preparing the domestic payments and securities settlement systems and the relevant participants.'

– 'In order to facilitate the smooth implementation of a carefully planned and developed action plan, the MNB intends to play a leading role at a national level in the practical preparations for the introduction of the euro and in the preparation of the domestic payments and securities settlement systems and the relevant participants.'

Euro changeover represents an important milestone in the European integration of the Hungarian national economy. Based on the core responsibilities of the MNB defined by the Act on the MNB, as well as on its role in the European System of Central Banks, it is the primary objective and interest of the MNB to ensure that the Hungarian financial system is duly prepared for the adoption of the euro, regardless of the actual date of changeover. In the course of the multi-annual process of the preparation, the MNB and the Ministry for National Economy jointly manage the elaboration and implementation of the tasks related to national changeover, within the framework of the NEC and in accordance with the applicable government decree.

In compliance with its core responsibility stemming from the heading of the Financial Sector Sub-committee of the NEC, the MNB provides for the smooth implementation of the currency changeover and ensures that the entire system of domestic payment services (including payment and securities clearing systems and all the relevant market participants) is prepared for adoption of the euro. The conversion into euro of bank accounts, loans and other financial products, the transformation of insurance products, the adjustment of retirement account services and the securities market, and the provision of IT and infrastructure background support for the changeover involve tasks which will directly affect Hungarian society as a whole. The MNB – through the chairmanship of the Communication Sub-committee of the NEC and relying on its extensive network of relations as well as on its own expertise in this special field – is also given the responsibility to play a leading role in the communication and information activities associated with the changeover. A fundamental requirement for the dissemination of information related to the euro changeover is that it should be credible, concerted, efficient and comprehensive when targeting the private, and more specifically, the households sector.

In parallel with its leading role in updating the NCP and in line with the provisions of the NCP, the MNB updates its own preparatory tasks in the Bank's intra-institutional euro changeover program.

3.8 CENTRAL BANK ACTIVITIES AIMED AT IMPROVING THE FINANCIAL LITERACY OF CITIZENS

Similar to earlier years, in 2011 the Bank prepared the information brochure entitled *'Money talks. Do you understand?'*, which was delivered to nearly 1,200 secondary schools. Copies of the information brochure were delivered to 118,000 secondary-school students of 17 years of age (in the penultimate academic year, immediately preceding their GCSE exams); an on-line teaching aid in the form of presentations also accompanies the brochures. A contest entitled *Monetary – közgazdálkodj okosan! (Monetary – Economise smartly!)* was organised for secondary-school students. The contest attracted 1,600 students and close to 300 teachers.

In 2011, the MNB Visitor Centre received close to 40,000 visitors, a great number of whom participated in programmes aimed at boosting economic and financial literacy. Information programmes such as open house days organised at week-ends in May and September, 'The Night of Museums' in June and 'The Autumn Festival of Museums' also contributed to the popularity of the Centre. The MNB Visitor Centre managed four off-site events in 2011: 'The May Day of Museums', 'The City Park Children's Day' organised by the International Service for the Safety of Children, the Island Festival and (for the first time in 2011) the VOLT festival in Sopron.

Relying on the ways and means at its disposal, the Bank also assisted teachers actively involved in raising financial literacy. It organised a national seminar for teachers in December, striving primarily to strengthen professional relationships between the Bank and teachers engaged in practical training. Furthermore, thanks to presentations on the banking profession, participants were provided with first-hand information about the Bank's activities that they do not or hardly find in ordinary textbooks.

The MNB also made financial contributions to several initiatives other than its own, aimed at enhancing and promoting financial literacy. Amongst other things, it provided financial support for the organisation of the National Conference of Students' Scientific Study Circles and a series of lectures aimed at the dissemination of financial literacy delivered at Miskolc University and organised by the Association of Business Management and Scientific Societies.

The Money Compass Foundation has been providing professional and financial support for the Educational Programme for Financial Literacy (EPFL) aimed at promoting financial literacy among secondary school children for four years. A total of 5,500 students and 278 teachers have participated in the programme over the past three completed programme years. In the 2011/2012 academic year, a further 60 secondary schools decided to join the programme, translating into the participation of another approximately 2,800 students. The Foundation also provided a 30-hour accredited advanced education programme, with the economy as its focus, for teachers participating in the programme. The Foundation also relied on the course materials of the education programme to support initiatives targeting younger generations.

The institutions of education participating in the EPFL are the backbone of the Money Compass network of schools established by the MNB, the Foundation and the Ministry of Education in order to grant recognition to schools which play a leading role in the dissemination of financial literacy. As of the end of 2011, the network consisted of 82 institutions of secondary education, including 60 EPFL schools, with a total number of close to 80,000 students from the member institutions.

Coordinated by the Foundation, a programme – the first of its kind in Hungary – aimed at shaping financial thinking and disseminating financial literacy was launched in May 2011. Under the programme, starting in May 2011, the monthly publication of nearly 700 articles and materials of independent editorial staffs disclosing practical financial knowledge needed for daily life are planned in 22 media for 15 months in succession. Topics will vary, and approximately 4 to 5 million persons are intended to be reached on a regular basis. The importance of the Programme is underscored by the fact that it is the first national programme to win over nearly all the actors with a significant market share in the sector for the purpose of raising the level of the population's financial literacy and to raise funds in the market for this purpose.

At the joint request of the Bank and the Money Compass Foundation, a national survey relying on a representative sample of 1,000 persons was conducted in order to assess the financial literacy of the population and the pattern of their purchasing and using financial products. Publication of the results of the survey in April 2011 generated significant interest in the profession and the media.

The Bank and the Foundation were also represented at a number of conferences on the enhancement of financial literacy and personal financial security; furthermore, media presence and interviews also focused on this activity of the Bank and the Foundation.

The MNB also plays an active role in promoting financial literacy at the international level. At the request of the OECD, the Financial Literacy Centre of the Bank participated in a working group established to carry out the methodological preparations of an international comparative study and, as a permanent member, it also contributes to OECD's International Gateway for Financial Education.

3.9 FACTORS SHAPING THE COMMUNICATION OF THE MNB IN 2011, TARGETS AND RESULTS

The Bank's main objectives for its 2011 communication included the maintenance and strengthening of the success of the inflation targeting system, the efficiency of the monetary decision support system and the stability of the Hungarian financial system as well as their support by the means of communication. As in previous years, in 2011 as well the MNB's communication activity focused on enhancing the MNB's reputation, recognition and credibility as well as providing information on its duties and activity for the general public.

As a result of the successful central bank communication (proactive relations with the press, analytical publications and publications for the general public, a campaign for the UV-A/C programme), the Bank's operation, activity and role have become more straightforward and transparent for members of the public and professionals alike. In 2011, the MNB issued 76 press releases alone; in other words, it relayed its messages consistently to the various target groups through the press. The MNB's Communications Department made adjustments to the new challenges of a changing environment through consistent theme management, purposeful selection of dedicated experts representing the Bank's interests authorised to make announcements and the strengthening of media relations.

Thanks to our forward-looking media relations management, we secured significant media presence related to the UV-A/C programme on 97 occasions. We first used Twitter as a means of communication in connection with the UV-A/C programme on a test basis.

On the whole, through the use of the state-of-the-art tools of contemporary strategic communication, the MNB strove to ensure that all of the complex activities it performs in the interest of the public good are transparent and effective, and its messages reach the target audiences efficiently.

3.10 THE MNB'S INCOME IN 2011

In 2011, the MNB earned a profit of HUF 13.6 billion. The financial result and balance sheet structure of the Bank are primarily determined by the domestic and international macroeconomic developments and the objectives and selected measures of the monetary policy. In 2011, the following main developments had an effect on the balance sheet and the profit:

– the level and composition of foreign exchange reserves defined by monetary policy, and foreign exchange purchases and sales affecting the level of reserves; operations by the Government Debt Management Agency linked to debt management, net foreign exchange inflows from EU transfers, and the foreign exchange conversions performed by the Hungarian Treasury for purposes unrelated to debt-financing and euro-sales tenders linked to the early repayment of FX mortgage loans granted to households;

– developments in instruments absorbing forint liquidity, which are correlated with changes in foreign exchange reserves and the MNB's net foreign currency receivables;

– changes in forint interest rates and international foreign exchange interest rates; and

– changes in the forint exchange rate.

In 2011, interest income was fundamentally determined by the increase in the Bank's net foreign currency receivables, which resulted in growth in interest-bearing forint liabilities. Net interest and interest-related losses amounted to HUF 94 billion, representing a deterioration of HUF 40.2 billion on a year earlier.

Net forint interest and interest-related losses amounted to HUF 312.7 billion in 2011, HUF 67.4 billion higher than a year earlier. The lower interest income is due to the fact that foreign currency inflows from EU transfers and the Government Debt Management Agency's financing operations generated excess HUF liquidity in the economy through FX conversion upon the utilisation of such FX inflows, which caused an increase of two-week MNB bills among the liabilities of the central bank. The annual average stock of forint liabilities where interest-bearing is pegged to the base rate (forint deposits of the central government, minimum reserves and liquidity absorbing instruments), increased by nearly HUF 570 billion. Another factor was an increase in the base rate. The average central bank base rate weighted with calendar days was 57 basis points higher than in 2010.

Net foreign exchange interest and interest-related profit amounted to HUF 218.7 billion, HUF 27.2 billion higher than a year earlier, due to increase in interest income from FX reserves. This was attributable to several factors: one was the increased amount of FX reserves, the other was EUR yields, which were higher at an annual average level than in 2010 on maturities of 1 to 2 years, i.e. maturities that bear

Table 4
Abbreviated income statement and individual balance sheet items of the MNB

HUF billions

No.	Description (P/L line)	2010	2011	Change
1	Net interest and interest related income (I+II)-(X+XI)	−53.8	−94.0	−40.2
2	*net forint interest and interest related income (I-X)*	−245.3	−312.7	−67.4
3	*net foreign exchange interest and interest related income (II-XI)*	191.5	218.7	27.2
4	Realised gains/losses arising from financial operations (IV-XIV)	−21.7	24.7	46.4
5	Income arising from exchange rate changes (III-XII)	50.4	98.7	48.3
6	Other constituents of net income* (V+...+VIII)-(XIII+XV+...+XVIII)	−16.5	−15.8	0.7
7	**Profit/loss for the year (1+4+5+6)**	**−41.6**	**13.6**	**55.2**
	Revaluation reserves in the balance sheet			
8	*due to unrealised foreign exchange gain/loss*	415.9	1,325.0	909.1
9	*due to changes in the market value of the foreign currency securities***	−29.1	5.6	34.7

** Net P&L of banking operations, costs of issuing banknotes and coins, net creation and release of provisions, income/expenses from commission and from other items.*
*** Pursuant to the MNB Act, the central government reimbursed the negative balance as at 31 December 2010 of the reserves by 31 March 2011.*

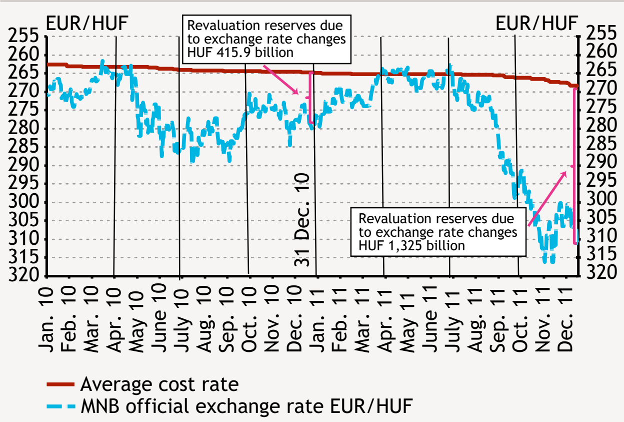
relevance to reserves, and the third factor was the significant depreciation of the forint, leading to a rise in HUF-denominated interest. Average interest converted into HUF on FX reserves amounted to 2.6 per cent in 2011, which was 0.1 per cent higher than in 2010.

Realised total profit arising from financial operations amounted to HUF 24.7 billion. This category of P&L mainly states P&L realised from changes in the market prices of securities included in the FX reserves as well as realised gains or losses on Hungarian government bonds and mortgage bonds in the case of maturing instruments or the sales of instruments. In the first half of 2011, rising FX market yields still led to realised losses; by contrast, in the second half of 2011 declining yields generated sizeable profits. The Bank realised losses in the amount of HUF 3.3 billion on HUF government bonds removed from the portfolio.

The two main factors determining the income arising from exchange rate changes are the difference between the official and the cost rate as well as the volume of foreign exchange sales. The volume of FX sales was customary for the most part of the year; it started to rise from October due mainly to the euro-sale tenders introduced in connection with the early repayment of FX mortgage loans, and a few instances of larger-than-usual FX conversion (FX sale transactions with the Government Debt Management Agency, VAT refunds and European Commission-related conversion). The other main factor was the difference between the official and the cost rate brought about by the weakening of the forint in the second half of the year, with the difference more than tripling from EUR/HUF 14.01 as of end-2010 to EUR/HUF 42.11 by 31 December 2011. It is these two factors that contributed to the Bank being able to post HUF 98.7 billion in HUF exchange rate gains in 2011, which was nearly twice the amount in 2010.

Chart 22
Trends in the forint exchange rate

(an inverse scale)



Other income and expense items include general operating income, costs and expenses, costs of issuing banknotes and coins, creation and release of provisions, income/expenses from fees and commissions and from items other than fees and commissions. Resultant net expenses decreased by HUF 0.7 billion in 2011, due, in part, to lower costs of banknotes and coins production and, in part, to lower operating expenses; By contrast changes in net provisions and impairment resulted in weaker financial performance.

Compared to the end of the previous year, the MNB's equity increased by HUF 928.2 billion to HUF 1,387.6 billion. Fundamentally, it was affected by the level of revaluation reserves (which in turn were affected by exchange rate changes). Yet developments in annual profit/loss also played an important role in the increase.

Due to exchange rate changes, revaluation reserves increased by HUF 909 billion compared to the end of 2010. This is due primarily to the growing gap between the official forint exchange rate and the average cost rate. An increasing stock of revalued foreign currencies (net FX position) also contributed to the growth. As of 31 December 2011, the closing value of revaluation reserves due to exchange rate changes was HUF 1,325 billion.

As of 31 December 2010, the negative balance of HUF 29.1 billion of the revaluation reserves of foreign currency securities was reimbursed by the central government. As a result of a favourable change in the market price of foreign currency securities, HUF 5.6 billion in unrealised gains was generated on the revaluation reserves of foreign currency securities.

3.11 FINANCIAL PERFORMANCE OF THE MNB

The MNB's operating costs and capital investments in 2011

The internal operations of the MNB are essentially aimed at providing the resources required for an efficient discharge of the duties stipulated by the MNB Act and for facilitating risk-free operations in the most cost-effective manner.

Operating costs amounted to HUF 11,882 million in 2011, 7.0 per cent (i.e. HUF 901 million) lower than a year earlier. Over 40 per cent of the amount saved was due to depreciation write-offs; most of the write-offs occurred as scheduled. This is because, thanks to measures taken by

Table 5
Operating costs of the MNB in 2011

Description	Actual data for 2010	Budget for 2011	Actual data for 2011	Index (2011 actual / 2011 budgeted)	Index (2011 actual / 2010 actual)
	HUF millions			%	
Staff expenditures	7,009	7,023	6,884	98.0	98.2
General operating costs	5,774	5,820	4,998	85.9	86.6
Total	**12,783**	**12,843**	**11,882**	**92.5**	**93.0**

the Bank three years ago, rates of amortisation are better adjusted to the useful life-cycle of assets (the value of some of the assets purchased in earlier years was written off earlier than the length of actual use).

Operating costs decreased, however, by a lower amount than amortisation. This is due mainly to the fact that the building at Szabadság Square is now run by a single operator. Use of the building at 7 Hold Street ended in June 2010, and the operation and the maintenance service contracts of cash logistics equipment were streamlined. Other costs further declined, due mainly to the centralisation of tasks (i.e. transfer of tasks to the state) related to Holocaust litigation. The same applies to personnel expenses, owing especially to a reduction in the income of the governor, the deputy governor and members of the Monetary Council, as a result of an amendment to the applicable legislation. A reduction in the average staff of the MNB was another contributing factor.

Taking into account the fact that the total operating cost of the MNB amounted to HUF 14,911 million in the year when the project aimed at improving the efficiency of the Bank's operation was first launched, the total amount of savings over the past three years has been over HUF 3 billion, or over 20 per cent reduction at a nominal value relative to costs in 2008. The Bank has managed to save costs primarily through implementing the aforementioned initiatives of the project and through a change in attitude, resulting in focus on cost-efficient solutions. A further contributing factor is interim changes in pertinent legislation, leading to lower costs.

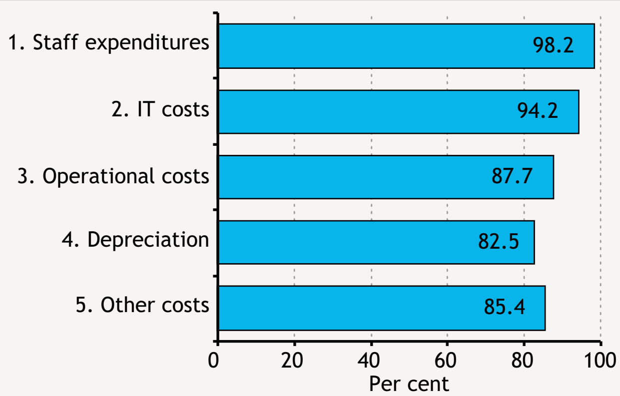
Overall, operating costs in 2011 calculated at a nominal value were below HUF 12 billion for the first time in the past decade.

The financially realised value of investment implemented in 2011 was HUF 775 million, much less than that of the previous year. One of the underlying reasons is that the investment plan was for a significantly lower budget in 2011 than in 2010, because investments incurring significant costs in connection with work stations in the Szabadság Square building were completed in 2010. Furthermore, the upgrades linked to the IT strategy did not entail higher investment expenditures in 2011 than in earlier years. The Bank's investment plan for 2011 was implemented to a degree of 54.1 per cent, which is due primarily to a significant number of the investments carried over into 2012 and the amount of the funds required for them. Of these, the upgrades that have been carried over into 2012 and involve sizeable amounts of financing are as follows: upgrading of the telecommunication system used by market operation staff (HUF 70 million), increased accountability of IT operators (HUF 68 million), implementation of an audited file management system (HUF 35 million), replacement of DWDM tools (HUF 32 million) and the upgrading of statistical systems (HUF 28 million).

Operating costs

The approved operating cost budget for 2011 was HUF 13,036 million (including central reserves in the amount of HUF 193 million). In comparison, actual costs amounted to HUF 11,882 million. This amount represents 7.0 per cent (or HUF 901 million) reduction in operating costs over 2010; this reduction affected most cost types, with depreciation costs falling to the largest extent and greatest amount.

Chart 23
Ratio of operating costs in 2011 to actual data in 2010



Staff expenditures

Personnel expenses in 2011 (HUF 6,884 million) dropped by an overall 1.8 per cent (more than HUF 120 million) relative to 2010, owing especially to reduction in the income of the governor, the deputy governor and members of the Monetary Council as a result of an amendment to the applicable legislation. A drop in the staffing levels of the MNB was another contributing factor. Another underlying reason for lower costs was reduction (from 25 per cent to 19.04 per cent) in employer's PIT, due to changes in the applicable statutory regulations. Savings from the above factors were reduced by a wage increase in early 2011.

General operating costs

General operating costs in 2011 (HUF 4,998 million) fell by 13.4 per cent, compared to 2010.

IT costs were HUF 70 million lower in 2011 than in 2010, owing predominantly to favourable prices negotiated during procurement procedures aimed at supporting the operation of IT equipment and a reduction in contracted, man hour-based support and troubleshooting services. Costs incurred by the engagement of contracted consultants also decreased as an outcome of higher reliance on internal resources and knowledge.

Facility operation costs also fell (by HUF 190 million) relative to 2010, due in part to the fact that the central building at Szabadság Square is now run by a single operator (implementation of an initiative in the project aimed at the improvement of operating efficiency) and in part to the fact that use of the building at 7 Hold Street ended in June 2010 (which resulted in cost-savings in respect to 2011 as a whole). Reduction in costs of the operation of cash logistics equipment, 'in-sourcing' of the operation of the automatic depository and the fact that fees payable under the new contract concluded for the maintenance of banknote processing machines were more favourable than before were all linked to another objective of the project aimed at the improvement of operating efficiency. Reduction in costs was also attributable to unscheduled measures based on a deliberate cost-saving approach in connection, especially, with facility operation-related work and costs.

The amount of *depreciation write-offs* (HUF 1,800 million) decreased by 17.5 per cent (HUF 380 million) in 2011, compared to a year earlier, mostly in keeping with the plan. This is due to the Bank's measures three years ago and the fact that rates of amortisation are better adjusted to the useful life-cycle of assets (the value of some of the assets purchased in earlier years was written off earlier than the length of actual use). Planning also took into account the fact that the portfolio of assets completely written off was on the rise. Furthermore, certain capital projects were completed later than planned or their implementation was carried over into 2012, which led to slightly reduced amortisation costs in 2011.

Other costs in 2011 also declined relative to a year earlier. Over HUF 96 million of the overall HUF 140 million decrease is linked to Holocaust litigation, whose tasks and costs to be borne were transferred to the Minister for National Development, acting on behalf of the Hungarian State. Reduction in other costs was attributable to communication costs being HUF 40 million lower in 2011 than a year earlier because of a protracted procurement procedure aimed at the selection of a new communication agency.

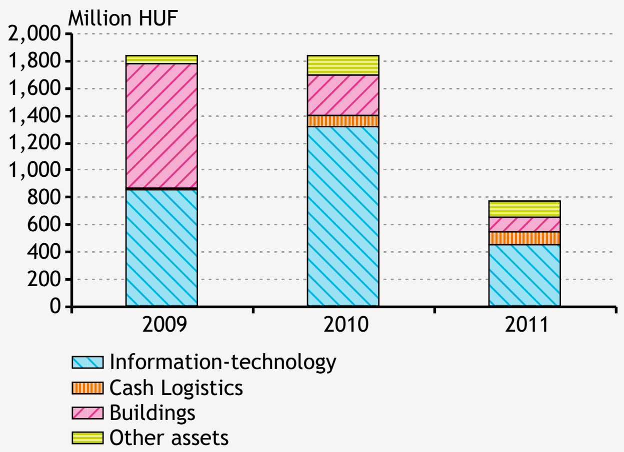
The lease fee paid by Magyar Pénzverő Zrt. for the use of part of the Logistics Centre and, recognised as a book transfer, income from services related to welfare activities amounted to HUF 127 million, which led to a reduction in general banking operation costs.

Capital expenditure

In December 2010, the governor approved a capital expenditure budget of HUF 1,434 million for new investments in 2011 and investments with an updated schedule and value in a manner that appropriation for investments in progress pursuant to earlier decisions had been taken into account. The budget for investments in 2011 was much more modest than in 2010. The underlying reason for this is that investments incurring significant costs in connection with work stations in the Szabadság Square building were completed in 2010 and upgrades linked to IT strategy did not entail higher investment expenditure in 2011 than in earlier years.

Capital expenditure was roughly the same (HUF 1,839 million in both 2009 and 2010). The value of capital projects implemented in 2011 was HUF 775 million, much lower than in past years. Underlying reasons included a lower budget for 2011 and the fact that several capital projects will be completed in 2012. Furthermore, through the joint efforts of cost bearers and the Central Procurement Department, numerous assets were purchased at a price lower than planned. Another contributor to savings was the reliance of IT Services on its own resources in implementing several IT upgrades.

Chart 24
Trends in the MNB's capital expenditure



The majority of capital projects in 2011 were linked to the upgrading of IT infrastructure. Of these, the most important was the purchase of workstations for users. Both desktops and laptops were purchased in order for obsolete PCs to be replaced. Two SAN (Storage Area Network) directors were purchased for redundant central data storage. These network tools manage data flow between data stores. Aimed at reducing risks related to the management of clearing portfolios, a GiroNet upgrade was implemented in the Inforex system. In order for TEMPEST standards to be met, hardware needed for the storage of confidential data had to be purchased for the Office for the Registration of Qualified Data, software had to be adapted to the new environment and legacy data had to be migrated.

The quality of the information system supporting central bank statistics is of crucial importance, and an essential condition for this activity is the availability of high-quality IT support. In 2010, the Integrated Statistical System programme continued, within the framework of which the Monetary Statistical System was upgraded. Upgrades warranted by changes in statistics-related decrees were also implemented. An assessment of the PSZLA system was performed as part of the preparation for statistical changes due in 2014.

Linked to the medium-term goals of the MNB, a number of minor capital projects were carried out in 2011 to improve efficiency and effectiveness. Server virtualisation continued, warranting the purchase of server and hardware licences. After critical and non-critical IT systems were separated, a liberalised working environment was established, making possible a less restricted use of several applications (e.g. journey management system and working hours registry system).

As regards capital projects linked to real property, in order for buildings to be utilised more reasonably, the archive at Soroksári út was moved to the Logistics Centre; this necessitated the installation of new shelves. Upgrading of the uninterrupted power supply system in the building at Szabadság Square was part of the improvements of that building. The upgraded system provides an uninterrupted power supply for all the office PCs, the telephone exchange, the server room of the Money and FX Market Department, and the bank security systems of the building.

In order to improve banknote protection, the Cash Logistics Department purchased bank note detectors for testing purposes in 2011 and carried out an upgrade related to machine-based detection of wear and tear of banknotes. Furthermore, an upgrade aimed at achieving a higher degree of automation of the inner processes of logistics was also carried out.

Among other capital projects implemented in 2011, passenger cars were purchased to replace obsolete vehicles. To comply with information protection considerations, computers operating and overseeing telecommunication systems were integrated into a single telecommunication network system, making possible identical error detection, identical access code management and simpler and more transparent system surveillance. In addition to the above, purchases needed for daily work (e.g. mobile telecommunication tools and uniforms for security guards) were made and recorded as other capital projects.

Human resources management of the MNB

Activities in 2011 focused on strengthening employee commitment and the improvement of certain HR systems, contributing to the implementation of HR strategy. In order for these goals to be achieved, both employees and all levels of management had to be won over. Initiatives targeted the following main areas:

Promotion and career management

Results of the employee commitment (loyalty) and satisfaction survey in 2010, the internal client survey in 2011 and HR Mirror research all confirm the effectiveness and favourable adoption of our career development efforts. Therefore, earlier initiatives continued: we continued to organise career training programmes in order to identify ambitions targeting personal development and promotion and to support their realisation in 2011; face-to-face career consultations were also made available. Furthermore, career maps of organisational units were defined in order to plan expert career paths and further awareness of them. In

2011, we re-launched the 'Leadership Potential Programme' in order to make it possible to fill internal vacant managerial positions; under the scheme, a nomination process was initiated to find suitable candidates.

Consistent with earlier practices, in order to achieve the institutional objectives of the MNB, a key task was to ensure that the Bank has a committed and dedicated expert staff with a professional track record and competence matching the Bank's profile; therefore, a priority was to provide support for managers to identify and train key experts and talented individuals. Towards this end, a model facilitating 'HR potential review' and a related manual were set up and compiled. Both offer consistent criteria, facilitating managers' long-term thinking about the future development of their respective organisational units and staff.

Development

In 2011, the development of managers focused on enhancing operations and influencing employee motivation and commitment. Key issues were the personal efficiency of managers and their abilities to encourage and provide feedback for employees. In order to ensure a consistent executive culture, we also involved lower level executives.

The 'Managers Club' organised for departmental heads was also adjusted in line with the above focus. Topics included talent management and informal communication.

Based on the 360-degree survey of managers, strong emphasis was placed on the development of mid-managers. Action learning groups were established in order to shape executive roles in accordance with the prescribed role model, to ensure consistency between operational and leader-type abilities, and to support personal needs for skill development. Furthermore, a series of programmes were organised to support newly appointed senior officers.

In order to use HR systems more effectively, the HR Department organised workshops for managers at all levels of the organisational hierarchy. The objective of these workshops was to share dilemmas that had arisen in connection with flexible working, to exchange experience and to support performance evaluation practices in connection with the development of performance evaluation systems.

Development of the performance management system

In order to strengthen the effect of incentives of the Bank's performance management system, based on 2010 surveys involving managers and employees and identified best practices, we upgraded the performance management system in 2011 in order to grant recognition to performances reflecting high professional standards, to send positive messages of confirmation and to provide future- and development-oriented feedback shaped by managerial expectations. The upgraded version for performance evaluation was already used in 2011.

In order to strengthen a performance-oriented institutional culture encouraging consistent and continuous development, we established a 'Bank's Top Performers' Award, which enables the Bank's top managers to grant recognition to staff members whose performance is outstanding in a given year.

Internal client satisfaction survey

The internal client satisfaction survey, conducted every two years, provides the organisational units participating in the survey with a comprehensive picture of the satisfaction of the Bank's employees as internal clients. The survey is carried out in order to facilitate internal co-operation and, based on employee feedback, to enable organisational units to better adapt their services to employee needs. Recognition of the value of the survey is corroborated by the fact that, including the departments that have decided to participate in the survey, the total number of organisational units involved is now ten. Once the survey was completed, HR partners and the organisational units interpreted the results jointly; based on these, in early 2012 the organisational units formulated an action plan to be implemented during the course of the year, in order to improve the quality of services provided.

A review of the remuneration policy

In response to the turbulence experienced in the economic environment over the past three years and the changes in wages offered by commercial banks, the MNB's remuneration policy was reviewed in 2011. The Bank conducted a benchmark survey that had already been conducted at European central banks. Involving an external consultancy firm, it examined the internal equitability and, based on trends in the current labour market and commercial bank remuneration practices, the competitiveness of its remuneration system. Relying on the results of the review, the MNB formulated its remuneration policy for 2012-2014.

Incentives for research

One of the MNB's priorities for 2011 is to better embed research in its professional activities. Towards this end, an organisational development process aimed to promote co-operation between the Research Department and analyst departments was launched. The Research Department revised its former strategy and, in line with the revised strategy, began the professional co-ordination of research activities at the MNB. It also implemented all those initiatives that ensure that the former framework of co-operation is revamped and that new opportunities of co-operation are utilised.

Accordingly, an internship programme was launched. In 2011, five interns joined this 18-month internship programme. Interns are scheduled to spend six months at each of the following analyst departments: Monetary Strategy and Economic Analysis, Financial Analyses and Financial Stability. The objectives of the programme are to recruit interns in order to save time for senior staff so that they can better focus on research and to provide talented, ambitious and committed undergraduates in the field of economics in their final year of university with an excellent opportunity to gain experience and help from the MNB as a responsible institution in finding suitable jobs in the labour market. The undergraduates participating in the programme also bring up-to-date knowledge and a new attitude with them, thereby contributing to the dissemination of central bank-specific information and knowledge.

Updating of the Code of Conduct

In 2011, as part of a regular review process, workshops were organised in order for managers and employees of the MNB to review the MNB's Code of Conduct. Based on issues raised in these discussions by staff members and the recommendations of managers, the Code of Conduct was revised and more details were added in a manner that changes in internal operation and the institutional environment of the Bank were taken into account. An updated Practical Guide, published in electronic format and offering examples, accompanies the Code of Conduct to help in its interpretation.

Staff number and fluctuation

In 2011, the average staff number of the MNB was 590.3 (i.e. 1.1 employees less than the previous year). At the end of 2011, the total staff number was 582 people; the number of employees was 7 persons (1.2 per cent) fewer than at the end of 2010.

The staffing levels of the MNB in 2011 were influenced by the following scheduled recruitments and terminations of employment:

– Increase in tasks and staffing levels associated with the role of the MNB's governor in the Fiscal Council;

– Increase in tasks and staffing levels associated with enhanced protection against banknote counterfeiting;

– Introduction of internship at the MNB;

– Reduction in staff due to changes in the work processes of the Banking Operation Department;

– Reduction in staff due to the 'night stocks of banknotes' capital project;

– Reduction in staff due to the remodelling of the archives.

Table 6
Changes in labour flow indicators 2011

Indicators	2010	2011
Fluctuation		
Fluctuation (departing employees + new entries/2x total headcount)	9.6%	10.6%
Departure rate (departing employees / total headcount)	10.7%	11.9%
Voluntary departure rate (ratio to total headcount)	4.4%	4.6%
Voluntary departure of key employees	2	6
Voluntary departure rate of key employees leaving the country	0.0%	16.7%
Recruitment		
Recruitment needs	52	46
Ratio of recruitments to replace departing employees to total rectruitment needs	63.5%	93.5%
Ratio of new entries to total headcount	8.5%	9.3%
Open positions filled internally	37.3%	22.2%
Working time		
Working time exploitation	85.1%	85.0%
Sick leave time to total working time	1.6%	1.7%

The lower end-of-the year staffing level at the MNB was also due to the fact that finding replacements for the staff members who decided to leave on their own initiative was carried over into 2012.

In 2011, the employment of 70 employees was terminated. Termination was initiated by the employer in 32 cases and by employees in 27 cases, while 11 terminations were due to retirement or other reasons (e.g. expiry of fixed-term contract, etc.). In 2011, 55 persons were hired to fill vacancies or new positions.

As a result of these changes, the share of employees with a degree continued to increase in 2011, reaching a 2.5 per cent higher ratio than the previous year. A slight increase was observed in composition by age; the average age of employees was 41.1 years in 2011. Compared to the previous year, in 2011 the average length of employment at the Bank changed from 12.8 years to 12.6 years.

Procurement

Besides maintaining consistent compliance, the operation and organisational development programme ('The Transformation of the Procurement Strategy Project') implemented in 2010 approximated the Bank's procurement-related practice to the best competitive market practice.

The success of the completed project is attested to by the fact that more efficient work targeting the market resulted in healthier and stronger competition. In addition, a preparatory stage, a new component incorporated into the procurement process, led to a higher proportion of successful procurement procedures:

- The number of bidders grew by 20 per cent.
- The proportion of bidding companies/companies invited to bid rose from 68 per cent to 75 per cent.
- The average lead time of procedures decreased by 10 per cent.

The proportion of procurements implemented via e-auctions grew from 29 per cent in 2010 to 43 per cent in 2011, with average savings reaching 24 per cent.

As part of environmentally conscious operations, a procurement procedure launched to support the processing of e-bills was completed in March 2011. The first e-bills were received in April. Their ratio rose consistently from one quarter to the next (Q2: 193; Q3: 268; and Q4: 399) as new suppliers started to use the service. In the final quarter, one-third of the bills were sent electronically.

Public procurement procedures with a European reach (e.g. in connection with hotel accommodation fees and airplane tickets), in which the MNB also participated and which was overseen and supported by the Eurosystem's Procurement Co-ordination Office (EPCO), also contributed to savings on costs incurred by participation in the work of the various committees of the ESCB.

Implementation of environment-conscious operation

Over the past few years, the MNB has implemented a number of environmentally conscious capital projects and launched initiatives that led to tangible results in the environment-related performance of the Bank. The Green Office Competition in 2010 underpinned an earlier assumption, namely that the MNB had done well in respect to protection of the environment. It was granted the Greenest Office of 2010 Award.

Having assessed possible ways of further progress and being aware of the requirements of the EU Eco-Management and Audit Scheme (EMAS), the MNB decided to adopt the EMAS along with related EU registration. Before the environmental management scheme was designed, the MNB assessed factors significantly affecting the environment. It exerts continuous control over such factors, uses indicators to measure its environmental performance, strives to improve these indicators every year and discloses the related objectives and results. The MNB's Environmental Policy reflects the commitment of the MNB's management to environmental awareness and its embracing of the principle of sustainable development. The Environmental Policy lays down the main directions of improving performance:

- improving energy efficiency,
- increased protection of air as a component of the environment,
- implementation and development of state-of-the-art waste management.

In implementing its environmental policy, the MNB determines what steps to take on the basis of its responsibility of managing public money. Therefore, the MNB makes all initiatives and commitments aimed at improving its environment-related performance conditional upon the feasibility of achieving results and costs of implementation.

In 2011, the MNB drew up its Environmental Statement, had it certified by an external accredited EMAS-authenticator and disclosed this on its website.

In 2011, overall energy consumption and, within that, electricity consumption dropped by 7 per cent and 7.6 per cent (448,503 kWh) respectively, which translated into HUF 12.4 million in cost savings.

CO2 emission fell by 7.3 per cent, mainly in connection with energy consumption; in respect to off-site duty assignments, environmental pressure on air also dropped by 4.8 per cent in 2011.

Waste management is tightly monitored, as a result of which the proportion of selected waste grew significantly. The quantity of communal waste dropped markedly by 35 per cent in 2011; costs related to waste management were HUF 3.2 million lower in 2011 than in 2010.

3.12 INTRODUCTION OF THE ESCB COMMITTEES

Since Hungary's accession to the European Union, the MNB's management and experts have been participating in the work of ESCB committees and their working groups as full members. Within committees and working groups, the central banks of different nations have the opportunity to work together and formulate joint positions. This co-operation allows the representatives of individual national banks to obtain information about the work of the ECB on a regular basis.

Below is a brief summary of the fields of activity (mandates) of individual ESCB committees.

Accounting and Monetary Income Committee (AMICO): Develops and regularly reviews accounting policy principles which define the framework of financial statements in accordance with the Statute of the ESCB and the methodology of the preparation of regular financial reports, facilitating their co-ordination at an international level. Monitors the calculation of monetary income in accordance with the risk management process developed by the security framework system of accounting.

Banknote Committee (BANCO): Determines the euro banknote needs of euro area countries, co-ordinates the production of banknotes and works out the stockpiling and banknote processing policies of euro banknotes. Its tasks include the exchange of experiences gained from the production of euro banknotes, examination and development of security features to prevent euro banknotes from being counterfeited, and assessment of security risks related to the production of the euro. It contributes to the harmonisation of practices applied in the euro area, the development of the system which monitors counterfeiting, and the verification of statistics related to euro banknotes and coins.

Committee on Controlling (COMCO): COMCO has been an ESCB committee since July 2007 (only euro area NCBs participate in the work of this committee). COMCO contributes to the application and enhancement of the Common Eurosystem Cost Methodology, and it prepares analyses on the cost data and cost structure of certain functions and products of the Eurosystem/ESCB. In the area of management information systems, it serves as an important forum for co-operation and information exchange on issues concerning the ESCB as a whole.

Eurosystem/ESCB Communications Committee (ECCO): Contributes to the development of the external communications policy of the Eurosystem, the ESCB and the ECB for the purpose of making the objectives defined by the Eurosystem/ESCB more transparent and understandable, and for the purpose of informing the public about the tasks and activities of the Eurosystem and the ESCB.

Financial Stability Committee (FSC): The FSC has been operational since 2011, when the Banking Supervision Committee (BSC) ceased to operate. Its task is to provide professional support to the decision-making bodies of the European Central Bank in their tasks related to financial stability.

Internal Auditors Committee (IAC): By reviewing relevant common projects, systems and activities, and by providing for co-operation in certain auditing issues which are of 'common interest' for the ECB and national central banks, this Committee assists the ESCB in achieving its targets.

International Relations Committee (IRC): Assists in carrying out those tasks of the ESCB which are related to international co-operation. It contributes to formulating the position of the Eurosystem regarding the various areas of relations with non-EU countries; within the EU it analyses the status of the accession process to the EU and to the EMU and issues related to ERM II.

Information Technology Committee (ITC): Contributes to the development of the information technology policy and strategy of the Eurosystem and the ESCB, develops the related guidelines with special regard to security concerns, and provides technical advice to other committees. Furthermore, it initiates and implements Eurosystem and ESCB level developments and independent projects.

Legal Committee (LEGCO): Contributes to the maintenance of the regulatory framework of the Eurosystem and the ESCB, and monitors and reports on how national authorities and the Community comply with their consultation obligations related to draft legislation in areas falling within the competence of the ECB.

Market Operations Committee (MOC): Assists the ESCB in the implementation of single monetary policy and execution of foreign exchange transactions, including those related to the operation of ERM II and to the management of the ECB's foreign reserves, as well as in the appropriate adaptation of monetary policy tools applied by the central banks of Member States where the euro is yet to be introduced.

Monetary Policy Committee (MPC): Assists the ESCB in the implementation of the single monetary and exchange rate policy of the Community. Furthermore, it assists in the execution of the ESCB's tasks related to the co-ordination of the monetary and exchange rate policies of the NCBs of non-euro area Member States and the ECB.

Payment and Settlement Systems Committee (PSSC): Assists the ESCB in the smooth operation of the payment system, including the provision of advice on the operation of TARGET (Trans-European Automated Real-time Gross Settlement Express Transfer System), TARGET2, TARGET2-Securities, the SEPA (Single Euro Payment Area) and the CCBM (Correspondent Central Banking Model), as well as the cross-border use of collaterals. Furthermore, it supports the ESCB in general and 'oversight' issues related to payment systems, as well as issues concerning central banks in respect to securities clearing and settlement systems.

Risk Management Committee (RMC): The ECB approved the formation of this Committee in September 2010. The RMC only has euro area members. Offering analyses and putting forward recommendations, it provides assistance for decision-makers of the ECB in the management and control of risks arising from the market operations of the Eurosystem.

Statistics Committee (STC): Assists the ESCB in collecting statistical information required for the execution of its tasks. Inter alia, it contributes to the elaboration and cost-effective application of necessary modifications in statistical data collection.

Other committees assisting the work of the ESCB include:

Budget Committee (BUCOM): Assists the Governing Council of the ECB on issues concerning the budget of the ECB; it is composed of Eurosystem NCBs.

Human Resources Conference (HRC): The objective of this committee, which was established in 2005, is to serve as a forum for the central banks of the Eurosystem/ESCB in the exchange of information, opinions and experiences on issues concerning the management of human resources.

Eurosystem IT Steering Committee (EISC): The EISC was established in 2007 for the purpose of managing ongoing information technology developments in the Eurosystem with a special regard to responsibilities related to IT governance of the Eurosystem. It assists the Governing Council of the ECB in its decision-making process regarding joint information technology projects and operations with the Eurosystem/ESCB, contributing to the success and efficiency of IT management. It is composed of euro area NCBs.

Eurosystem Procurement Coordination Office (EPCO): This office, established in 2008, is tasked with facilitating the adoption of tested practices in the Eurosystem and developing the infrastructure required for joint purchases (e.g. skills, functional tools, IT systems and procedures); elaboration of common requirements in co-operation with central banks participating in joint tendering procedures; and supporting central banks in joint purchasing procedures.

3.13 PUBLICATIONS, CONFERENCES ORGANISED BY THE MNB IN 2011

Publications

Quarterly Report on Inflation

The Report on Inflation is published quarterly in order to enable the public to understand and follow the Bank's policies. The Report provides a regular presentation of past and future trends in inflation, evaluates the macro-economic processes key to inflation and provides a summary of the forecasts and considerations on the basis of which the Monetary Council takes its decisions.

Report on Financial Stability

Published twice a year, this report outlines the standpoint of the Bank regarding developments in the financial system and describes the effect of these changes on the stability of the financial system.

Beszámoló az MNB adott negyedévi tevékenységéről (Quarterly report on MNB's activities)

This quarterly publication briefly reports on the activities of the professional areas of the Bank in the previous quarter (e.g. monetary policy, overview of the financial system, foreign exchange reserves, payment transactions, currency-issuing activity, statistical changes).

Annual Report

This publication presents the Bank's business report from the previous year and its audited financial statements.

Report on Convergence

The MNB has been publishing this report since 2005. The report is usually published annually, thus it was also published in 2011. With this publication, the MNB intends to inform decision-makers, experts and the wider public on the complex issues related to membership of the monetary union.

MNB Occasional Papers

This series comprises and discloses economic analyses related to the MNB's monetary decision-making process. The series aims at increasing the transparency of monetary policy. Accordingly, in addition to studies describing the technical details of forecasting, the publication also covers the economic issues surrounding the preparatory work of decision-making.

MNB Working Papers

The series discloses the results of analyses and research conducted at the MNB. The analyses reflect the opinions of the authors and may not necessarily coincide with the official stance of the MNB. Since the autumn of 2005, the series has been available only in English.

MNB Bulletin

In 2011, the sixth issue of the Bulletin was published. The short articles it contains are intended to inform the general public in a comprehensible format about current economic trends and about the findings of research projects in which the Bank is involved. In 2011, the publication was issued three times.

Senior loan officer survey on bank lending practices

In the spring of 2003, the Bank first published this survey in order to facilitate a better grasp of bank lending processes. It supports an understanding of the way in which key domestic banks perceive and evaluate market processes, formulate their respective strategies and, within that, their lending policies. To enable closer monitoring of the qualitative aspects of the developments in loan supply, the Bank conducts the survey on a quarterly basis.

Public Finance Review

An expert team of the MNB conducts regular analyses of fiscal processes in order for the Bank to be able to conduct at the highest professional standard its tasks related to the definition and implementation of monetary policy. A new publication entitled 'Public Finance Review' enables the wider public to familiarise itself with the main results of expert analyses. The findings and conclusions disclosed in the analyses reflect the opinions of the analysts; they are not to be regarded as the official standpoint of the MNB or the Monetary Council. In 2011, the publication was issued twice.

Other publications

Aimed primarily at providing insight into transactions handled by the Hungarian payment market and Hungarian payment systems, an analysis entitled 'A hazai pénzforgalom számokban' (Facts and figures about domestic payment transactions) was published in 2011.

All publications of the Magyar Nemzeti Bank are available on its website (http://english.mnb.hu).

Conferences and presentations

Conferences and scientific events

10 March 2011 Conference on payments

15–16 April 2011 Economic Policy board meeting

3–4 May 2011 ECB cash logistics sub-committee meeting

26 May 2011 Central bank roundtable

10 June 2011 ECB-MNB Revisers' Seminar

9–10 September 2011 European Systemic Risk Board meeting

15–16 September 2011 10th Macro-economic policy research workshop on the restoration of the fiscal equilibrium, government debt and its national and global consequences

5–7 October 2011 Technical consultancy group meeting

11 October 2011 ESCB IAC working group meeting

8 December 2011 Horgony 2012

BESS at the MNB lectures

19 January 2011 Antonio Mele (London School of Economics): Ambiguity, information acquisition and price swings in asset markets

4 February 2011 Mehmet Fatih Ekinci (University of Rochester): Inattentive Consumers and Exchange Rate Volatility

7 February 2011 Markus Kirchner (University of Amsterdam and Tinbergens Institute): Expectations-Based Identification of Government Spending Shocks

9 February 2011 Adam Gulan (Rutgers University): Incomplete Markets, Optimal Portfolios, and International Consumptions Correlations

11 March 2011 Bela Személy (Duke University): Optimal Leverage and Investment under Uncertainty

23 March 2011 Bartosz Maćkowiak (European Central Bank): Business Cycle Dynamics under Rational Inattention

30 March 2011 Christian Matthes (Universitat Pompeu Fabra, Barcelona): Optimal Disinflation under Learning

20 April 2011 Simon Gilchrist (Boston University): Credit Spreads and Business Cycle Fluctuations

27 April 2011 Giovanni Calice (University of Southampton): Liquidity Interactions in Credit Markets: An Analysis of The Eurozone Sovereign Debt Crisis

11 May 2011 Gyuri Venter (London School of Economics): Short-sale Constraints and Creditor runs

18 May 2011 Romain Ranciere (Paris School of Economics): Financial Liberalization: Efficiency Gains and Black-Holes

1 June 2011 Anton Nakov (European Central Bank): Precautionary price stickiness

25 August 2011 Zoltan Pozsar (International Monetary Fund, guest researcher): Institutional Cash Pools and the Triffin Dilemma of the U.S. Banking System

5 October 2011 Boris Vujcic (National Bank of Croatia): Emerging Markets during the crisis: why this time was different?

26 October 2011 Giampiero Gallo (University of Florence): Common Dynamics in Volatility: a Composite vMEM Approach

9 November 2011 Andri Chassamboulli (University of Cyprus): 'Give me your Tired, your Poor', so I can Prosper: Immigration in Search of Equilibrium

16 November 2011 Dirk Schoenmaker (Duisenberg School of Finance): Improving the Resolution of Cross-Border Banks

30 November 2011 Francesco Pappada (University of Lausanne): All you need is Loan Credit market frictions and the exit of rms in recessions

Training courses at the Centre of Central Bank Education

Spring course 2011, Week 1, 5–8 April 2011:

Monetary and Fiscal Policy in the New Keynesian Open Economy Framework – Prof Tommaso Monacelli (Università Bocconi, IGIER, and CEPR)

Spring course 2011, Week 2, 11–8 April 2011:

Solving, Calibrating and evaluating structural models) – Prof Fabio Canova (ICREA Research Professor at UPF and CEPR)

Empirical time series methods for policy analyses – Prof Fabio Canova (ICREA Research Professor at UPF and CEPR)

Autumn course 2011, Week 1, 29 August–2 September 2011:

Monetary Policy, Asset Prices and Learning – Prof Klaus Adam (University of Mannheim)

Spring course 2011, Week 2, 5–9 September 2011:

Analyzing Business Cycles – Prof Adrian Pagan (University of Technology, Sydney)

3.14 EXPLANATION OF ABBREVIATIONS AND TERMS SPECIFIC TO CENTRAL BANKING

Abbreviations

ALCO: Asset-Liability Committee

AMICO: Accounting and Monetary Income Committee (an ESCB committee)

ATC: Advisory Technical Committee, a committee responsible for the technical preparation of the work of the European Systemic Risk Board.

BANCO: Banknote Committee (an ESCB committee)

BIS: Bank for International Settlements

BSC: Banking Supervision Committee (an ESCB committee)

BUCOM: Budget Committee

COMCO: Committee on Controlling (an ESCB committee)

CSO: Central Statistical Office

ECB: European Central Bank

ECCO: Eurosystem/ESCB Communications Committee (an ESCB committee)

EISC: Eurosystem IT Steering Committee

EMAS: Eco-Management and Audit Scheme

EMFESZ: First Hungarian Natural Gas and Energy Trading and Service Provider Limited Liability Company

EMIR: European Market Infrastructure Regulation

EMU: Economic and Monetary Union

EPCO: Eurosystem Purchasing Coordination Office

ESCB: European System of Central Banks

ESFS: European System of Financial Supervisors

ESRB: European Systemic Risk Board

FSC: Financial Stability Committee (an ESCB committee)

FSSC: Financial Sector Sub-Committee (a sub-committee of the NEC)

GIRO: Giro Clearing House Ltd.

HFSA: Hungarian Financial Supervisory Authority

HRC: Human Resources Conference

IAC: Internal Auditors Committee (an ESCB committee)

ICS: Interbank Clearing System

IMF: International Monetary Fund

IRC: International Relations Committee (an ESCB committee)

ITC: Information Technology Committee (an ESCB committee)

KELER: Central Clearing House and Depository Ltd.

KOMAB: Communications Sub-Committee (a sub-committee of the NEC)

LEGCO: Legal Committee (an ESCB committee)

MOC: Market Operations Committee (an ESCB committee)

MPC: Monetary Policy Committee (an ESCB committee)

NEC: National Euro Co-ordination Committee

NCP: National Changeover Plan

O/N: O/N, overnight (deposit/loan)

OECD: Organisation for Economic Co-operation and Development

OSAP: National Statistical Data Collection Programme (in Hungary)

PSSC: Payment and Settlement Systems Committee (an ESCB committee)

PSZLA: An IT application that compiles publication tables about the financial accounts of (all sectors of) the national economy

SAO: State Audit Office

SEPA: Single Euro Payments Area, an area within which, using one single payment account, economic agents may effect and receive payments in euro anywhere, in the same manner as in their own respective countries. Geographically, the Area covers the 27 EU Member States, Iceland, Liechtenstein, Norway, Switzerland and Monaco.

STC: Statistics Committee (an ESCB committee)

SWIFT: Society for Worldwide Interbank Financial Telecommunication, an international society specialised in secure financial messaging

TARGET: Trans-European Automated Real-time Gross Settlement Express Transfer system, the real-time gross settlement system of the euro area

VIBER: Real-time gross settlement system, a payment system operated by the MNB

Glossary

Cash turnover: The sum of exchanges and payments to and from the Central Bank.

Clearing: Control and transmission of payment transactions, calculation of interbank balances in accordance with specified rules; in the case of securities transactions: matching and confirmation of positions, calculation of accounts receivable/ payable and managing the arising financial risk.

Duration: Average remaining maturity of bonds. It is an indicator measuring the level of risk associated with the bond portfolio.

ERM II, Exchange Rate Mechanism II: An exchange rate mechanism for establishing the conditions for an exchange rate policy co-operation between euro area countries and EU Member States not participating in the third stage of EMU. The ERM II is a multilateral system of fixed but adjustable exchange rates, where the mid-rate is surrounded by a normal, ±15% fluctuation band. All decisions in relation to the mid-rate and, as the case may be, a narrower fluctuation band, are made on the basis of a joint agreement between the Member State concerned, the euro area countries, the ECB and the other Member States participating in the mechanism.

Foreign exchange swap: A usually short-term transaction involving the exchange of different currencies and, when the transaction is settled, exchange of the currencies again at the price determined in the contract by the cross rate and the interest rate of the currencies.

FX swap: See Foreign exchange swap.

IMF reserve quota: The freely drawable, i.e. not yet drawn portion of the IMF quota paid to the International Monetary Fund in SDR (Special Drawing Right).

Interest bearing currency swap transaction: A usually medium- or long-term transaction, involving the exchange of different currencies, a series of interest payments on the principal and repayment of principals when the transaction is settled.

Interest rate futures: A stock exchange transaction where the basis of future settlement is a certain amount of standardised (expressed-in-contract) deposits with interest rate specified at the time of the deal.

Interest rate swap: The exchange of fixed rate and variable rate interest on principal at determined intervals, adjusted to certain market rates and conditions.

Monetary financial institutions: The central bank, financial institutions and money market funds together constitute this institutional category within financial corporations.

Money market funds: Money market funds are investment funds the investment units of which are similar to bank deposits from the aspect of liquidity. Money market funds invest 85 per cent of their assets in money market instruments or transferable debt securities with a remaining maturity of maximum one year or instruments with a return similar to that of the interest rate of money market instruments.

Money market instruments: Low-risk, liquid securities traded in large amounts on markets where they can be exchanged for cash immediately at a low cost.

Option transaction: For the owner of the foreign exchange option this means a right, but not an obligation, to buy or sell a certain amount of currency against another currency at a pre-determined rate, at or before a pre-determined date. If the possessor of the option practises this right, it will become an obligation for the seller (writer) of the option.

Payment System Council: The decision-making body of the Payment System Forum.

Payment System Forum: An independent, self-organising, open professional organisation with consultative character committed to the matters of the domestic payment system and operating on the MNB's initiative, with the support of the Hungarian Banking Association and the involvement of market participants that play a decisive role in payment transactions as well as the Hungarian State Treasury, GIRO Zrt. and KELER Zrt. The supreme body of the Forum is the Payment System Council, which consists of the representatives of the members and operates under the co-chairmanship of the MNB and the Hungarian Banking Association.

Repurchase and reverse repurchase transaction: An agreement on the transfer of the ownership right of a security with a repurchase obligation at a pre-determined price at a future date specified or to be specified at the time when the contract is concluded. During the term of the contract the buyer may either obtain the security which is the subject of the transaction and freely dispose over it (delivery repo transaction) or may not obtain it and may not freely dispose over it, in which case the security is deposited as a bail to the benefit of the buyer during the term of the contract (hold-in-custody repo).

Revaluation reserve: The revaluation reserve of the forint exchange rate and the revaluation reserve of foreign exchange securities are reserves that are part of the equity of the MNB, which, in the event of a negative balance, to the extent of the negative balance, are paid by the central budget to the adequate revaluation reserve by 31 March of the year following the year in question. The amount of the reimbursement is recorded in the balance sheet of the current year as a receivable from the central budget. (The new MNB Act (Act CCVIII of 2011) entails changes in the rules of the reimbursement. For more details see Part B) Section 4.17)

Revaluation reserve due to forint exchange rate changes: Non-realised exchange rate gains and losses on the forint exchange rate changes of foreign currency assets and liabilities are to be indicated in the forint exchange rate revaluation reserve, which constitutes a part of the equity.

Revaluation reserve of foreign exchange securities: The valuation difference between the market value and cost rate of foreign exchange assets based on securities (except for repurchased foreign exchange bonds) is to be indicated in the revaluation reserve of foreign exchange securities, which constitutes a part of the equity.

ROA: Return on assets.

ROE: Return on equity.

Settlement: Final settlement of interbank liabilities and receivables on an account managed by a common bank, typically the MNB.

VaR (value at risk): A measure of risk, VaR quantifies the maximum amount of loss to be expected at a given confidence level for a specific time horizon.

Part B)
Audited financial statements of the Magyar Nemzeti Bank

1 Independent auditor's report

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This is an English translation of the Independent Auditors' Report on the 2011 statutory Annual Report of Magyar Nemzeti Bank issued in Hungarian. If there are any differences, the Hungarian language original prevails. This report should be read in conjunction with the complete statutory Annual Report it refers to.

Independent Auditors' Report

To the shareholder of Magyar Nemzeti Bank

Report on the Annual Report

We have audited the accompanying 2011 annual report of Magyar Nemzeti Bank (hereinafter referred to as "the Bank"), which comprise the balance sheet as at 31 December 2011, which shows total assets of MHUF 12,501,799 and retained profit for the year of MHUF 13,598 and the income statement for the year then ended, and supplementary notes, comprising a summary of significant accounting policies and other explanatory information.

Management's Responsibility for the Annual Report

Management is responsible for the preparation and fair presentation of this annual report in accordance with the provisions of the Act on Accounting and accounting principles generally accepted in Hungary, and for such internal control as management determines is necessary to enable the preparation of annual report are free from material misstatement, whether due to fraud or error.

Auditors' Responsibility

Our responsibility is to express an opinion on this annual report based on our audit. We conducted our audit in accordance with the Hungarian National Standards on Auditing (which are consistent in all relevant aspects with the International Standards on Auditing) and applicable laws and regulations in Hungary. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the annual report is free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the annual report. The procedures selected depend on our judgment, including the assessment of the risks of material misstatement of the annual report, whether due to fraud or error. In making those risk assessments, we consider internal control relevant to the entity's preparation and fair presentation of the annual report in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the annual report.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

We have audited the annual report of Magyar Nemzeti Bank, its components and elements and their accounting and documentary support in accordance with Hungarian National Standards on Auditing and gained sufficient and appropriate evidence that the annual report has been prepared in accordance with the provisions of the Act on Accounting and accounting principles generally accepted in Hungary. In our opinion, the annual report gives a true and fair view of the financial position of Magyar Nemzeti Bank as of 31 December 2011, and of its financial performance and of the result of its operations for the year then ended.

Report on the Business Report

We have audited the accompanying 2011 business report of Magyar Nemzeti Bank.

Management is responsible for the preparation of the business report in accordance with the provisions of the Act on Accounting and accounting principles generally accepted in Hungary. Our responsibility is to assess whether this business report is consistent with the 2011 annual report. Our work with respect to the business report was limited to the assessment of the consistency of the business report with the annual report, and did not include a review of any information other than that drawn from the audited accounting records of the Bank.

In our opinion, the 2011 business report of Magyar Nemzeti Bank is consistent with the data included in the 2011 annual report of Magyar Nemzeti Bank.

Budapest, 23 April 2012

KPMG Hungária Kft.
Registration number: 000202

István Henye
Partner, Professional Accountant
Registration number: 005674

2 Balance sheet of the Magyar Nemzeti Bank

HUF millions

Reference number to notes on the Accounts	ASSETS	31. 12. 2010	31. 12. 2011	Change
1	2	3	4	4–3
	I. Receivables denominated in forint	**313,642**	**287,150**	**–26,492**
4.3.	1. Receivables from the central government	278,593	168,501	–110,092
4.17.	of which: receivables to refund the revaluation reserve of foreign currency securities*	29,142	0	–29,142
4.7.	2. Receivables from credit institutions	35,041	118,641	83,600
	3. Other receivables	8	8	0
	II. Receivables denominated in foreign currency	**9,685,552**	**12,007,016**	**2,321,464**
4.9.	1. Gold and foreign currency reserves	9,280,373	11,604,514	2,324,141
4.4.	2. Receivables from the central government	1,792	747	–1,045
4.8.	3. Receivables from credit institutions	7,336	5,080	–2,256
4.10.	4. Other receivables	396,051	396,675	624
	III. Banking assets	**34,670**	**34,725**	**55**
4.13.	of which: invested assets	34,527	34,450	–77
4.15.	**IV. Prepaid expenses/accrued income**	**143,633**	**172,908**	**29,275**
	V. TOTAL ASSETS (I+II+III+IV)	**10,177,497**	**12,501,799**	**2,324,302**

Reference number to notes on the Accounts	LIABILITIES AND EQUITY	31. 12. 2010	31. 12. 2011	Change
1	2	3	4	4–3
	VI. Liabilities denominated in forint	**6,502,092**	**8,030,365**	**1,528,273**
4.5.	1. Central government deposits	272,559	597,010	324,451
4.8.	2. Deposits by credit institutions	830,600	1,317,580	486,980
	3. Banknotes and coins in circulation	2,361,601	2,693,412	331,811
4.11.	4. Other deposits and liabilities	3,037,332	3,422,363	385,031
	VII. Liabilities denominated in foreign currency	**3,172,249**	**3,046,512**	**–125,737**
4.5.	1. Central government deposits	804,216	786,048	–18,168
4.8.	2. Deposits by credit institutions	31,035	0	–31,035
4.11.	3. Other deposits and liabilities	2,336,998	2,260,464	–76,534
4.14.	**VIII. Provisions**	**3,352**	**4,166**	**814**
	IX. Other banking liabilities	**17,521**	**17,092**	**–429**
4.15.	**X. Accrued expenses/accrued income**	**22,920**	**16,084**	**–6,836**
4.16.	**XI. Equity**	**459,363**	**1,387,580**	**928,217**
	1. Share capital	10,000	10,000	0
	2. Retained earnings	75,003	33,426	–41,577
	3. Valuation reserves	0	0	0
4.17.	4. Revaluation reserves due to exchange rate changes	415,937	1,324,963	909,026
4.17.	5. Revaluation reserves of foreign currency securities	0	5,593	5,593
	6. Profit/Loss for the year	–41,577	13,598	55,175
	XII. TOTAL EQUITY AND LIABILITIES (VI+VII+VIII+IX+X+XI)	**10,177,497**	**12,501,799**	**2,324,302**

** Pursuant to the Article 17, paragraph (4) of Act on MNB the central government reimbursed the recievables by 31 March 2011.*

23 April 2012, Budapest

András Simor
Governor of the Magyar Nemzeti Bank

3 Income statement of the Magyar Nemzeti Bank

HUF millions

Reference number to notes on the Accounts	INCOME	2010	2011	Difference
1	2	3	4	4-3
4.19.	**I. Interest and interest related income denominated in forint**	**24,724**	**19,898**	**−4,826**
	1. Interest on receivables from the central government	18,024	14,650	−3,374
	2. Interest on receivables from credit institutions	1,885	3,570	1,685
	3. Interest on other receivables	0	0	0
	4. Interest related income	4,815	1,678	−3,137
4.19.	**II. Interest and interest related income denominated in foreign currency**	**254,292**	**287,215**	**32,923**
	1. Interest on foreign currency reserves	227,578	263,979	36,401
	2. Interest on receivables from the central government	0	0	0
	3. Interest on receivables from credit institutions	0	0	0
	4. Interest on other receivables	2,639	2,055	−584
	5. Interest related income	24,075	21,181	−2,894
4.20.	**III. Income arising from exchange rate changes**	**53,088**	**101,908**	**48,820**
4.19.	**IV. Realised gains arising from financial operations**	**52,310**	**81,273**	**28,963**
4.22.	**V. Other income**	**6,362**	**4,167**	**−2,195**
	1. Fees and commissions	821	1,076	255
4.23.	2. Income other than fees and commissions	5,541	3,091	−2,450
4.14.	**VI. Provisions released**	**2,623**	**950**	**−1,673**
4.14.	**VII. Impairment released**	**1**	**155**	**154**
4.24.	**VIII. Operating income**	**190**	**202**	**12**
	IX. TOTAL INCOME (I+II+III+IV+V+VI+VII+VIII)	**393,590**	**495,768**	**102,178**

Reference number to notes on the Accounts	EXPENSES	2010	2011	Difference
1	2	3	4	4−3
4.19.	**X. Interest and interest related expenses denominated in forint**	**270,038**	**332,550**	**62,512**
	1. Interest on central government deposits	23,319	33,094	9,775
	2. Interest on deposits by credit institutions	28,642	41,090	12,448
	3. Interest on other deposits	217,690	257,416	39,726
	4. Interest related expenses	387	950	563
4.19.	**XI. Interest and interest related expenses denominated in foreign currency**	**62,728**	**68,554**	**5,826**
	1. Interest on central government deposits	2,324	9,753	7,429
	2. Interest on deposits of credit institutions	63	129	66
	3. Interest on other liabilities	26,519	22,822	−3,697
	4. Interest related expenses	33,822	35,850	2,028
4.20.	**XII. Expenses resulting from exchange rate changes**	**2,718**	**3,223**	**505**
4.21.	**XIII. Cost of issuing banknotes and coins**	**8,547**	**4,887**	**−3,660**
4.19.	**XIV. Realised losses arising from financial operations**	**73,978**	**56,573**	**−17,405**
4.22.	**XV. Other expenses**	**2,259**	**1,573**	**−686**
	1. Fees and commissions	660	743	83
4.23.	2. Expenses other than fees and commissions	1,599	830	−769
4.14.	**XVI. Provisions charged**	**692**	**1,764**	**1,072**
4.14.	**XVII. Impairment**	**1,252**	**982**	**−270**
4.24.	**XVIII. Operating costs and expenses**	**12,955**	**12,064**	**−891**
	XIX. TOTAL EXPENSES (X+XI+XII+XIII+XIV+XV+XVI+XVII+XVIII)	**435,167**	**482,170**	**47,003**
	XX. PROFIT/LOSS BEFORE DIVIDENDS (IX-XIX)	**−41,577**	**13,598**	**55,175**
	XXI. Dividends from retained earnings	**0**	**0**	**0**
	XXII. Dividends	**0**	**0**	**0**
	XXIII. PROFIT/LOSS FOR THE YEAR (XX+XXI-XXII)	**−41,577**	**13,598**	**55,175**

23 April 2012, Budapest

András Simor
Governor of the Magyar Nemzeti Bank

4 Notes to the financial statements

4.1 THE MNB'S ACCOUNTING POLICY

The Magyar Nemzeti Bank, the central bank of Hungary, is owned by the Hungarian State. Ownership rights are exercised by the minister in charge of public finances (hereinafter referred to as the shareholder).

The accounting policy of the Magyar Nemzeti Bank is based on the Act on Accounting (Act C of 2000), Act CCVIII of 2011[12] on the Magyar Nemzeti Bank (hereinafter: the new MNB Act) and Government Decree 221/2000 (XII.19) on the special reporting and accounting requirements applicable to the Magyar Nemzeti Bank (hereinafter: MNB Decree). Since the effective date of the Act promulgating the international treaty on the accession of Hungary to the EU, i.e. 1 May 2004, the Magyar Nemzeti Bank has been a member of the European System of Central Banks (ESCB).

The following section presents a brief description of the accounting system of the MNB, and the valuation and profit recognition rules, whenever these differ from the general rules.

4.1.1 The MNB's accounting framework

One of the key accounting principles of the MNB is that transactions are booked for the period in which they occur, unless the financial year is already closed. This is especially important in terms of the accurate measurement of exchange rate gains and losses (see valuation rules), with special regard to foreign exchange sales and purchases. Spot foreign currency transactions which involve foreign exchange conversions are recorded in the books at the date of the transactions. Assets and liabilities arising from such transactions affect the MNB's foreign currency position from the date of entering into the transaction. The same procedure is applied to recording the revaluation difference in the balance sheet relating to derivative transactions for hedging purposes.

On a daily basis, the MNB records:

– exchange rate differences arising from revaluation of its foreign assets and liabilities and derivative transactions for hedging purposes recorded off-balance sheet, and

– accrued/deferred interest arising from on and off-balance sheet assets and liabilities from hedging transactions.

Pursuant to the MNB Decree, for the purpose of reporting data to the owner, the MNB is required to close accounts relating to its assets and liabilities and to net income on a quarterly basis, and to prepare trial balances following the procedure specified under its accounting policy.

For internal use, the MNB compiles a balance sheet and income statement every month, which are supported by the following:

– market valuation of foreign currency securities, with the exception of foreign currency bonds issued and repurchased by the Bank,

– split and recording of realised and unrealised portions of foreign exchange gains and losses deriving from daily revaluation, and

[12] Pursuant to Article 66 of Act CCVIII of 2011 the new MNB Act entered into force on 1 January 2012. The regulations of this Act shall be implemented in relation to 2011 financial statements. Up to 31 December 2011 Act LVIII of 2001 on the Magyar Nemzeti Bank was in force.

– charging of depreciation and amortisation.

Upon the quarterly closing of accounts, the MNB measures its off-balance sheet contingent and future liabilities arising from derivative transactions for other purposes and securities lending operations based on international agreements (in this case the liabilities are equal to the purchase value of the collateral received), and at the end of the year the invested assets, securities, claims and other off-balance sheet liabilities. As a result of this measurement, the Bank recognises impairment losses as necessary and forms provisions for liabilities and expected losses.

The balance sheet date is 15 January of the year following the reporting year with the exception, if it is not a working day, the last working day before.

By law, the MNB is also required to report to Parliament. The MNB submits one single report to both Parliament and the Ministry for National Economy, which as it is in charge of public finances, exercises the rights of ownership as laid down in the MNB Act. This takes the form of an Annual Report, which contains a business report describing the MNB's structure, operations and state of affairs in the reporting year and the MNB's annual financial statements defined by the Act on Accounting, as adopted by the executive board and approved by audit certificate. The supervisory board submits an opinion on the Annual Report and makes a report on such to the shareholder. The Annual Report is published in unabridged form on the Internet. The website is accessible at: http://english.mnb.hu.

The MNB Decree does not require the Bank to draw up consolidated financial statements. Consequently, as subsidiaries have no material impact on its balance sheet or profit, the MNB does not prepare consolidated financial statements.

In the course of its credit qualification process, the IMF ordered the MNB to present the distinctions detailed in Section 4.26 between MNB's accounting policy and the Guideline of the European Central Bank on the legal framework for accounting and financial reporting in the European System of Central Banks ECB/2010/20 (hereinafter: ESCB Guideline) as well as the numeric effect of these differences in the notes to the financial statements.

The financial statements of the MNB must be audited by the statutory auditor in compliance with the Act on Accounting. The registered auditor of the MNB is István Henye (KPMG Hungária Kft.), Chamber membership number: 005674.

The person authorised to sign the Annual Report is András Simor, Governor of the Magyar Nemzeti Bank.

The person responsible for accounting services is Gábor Kalina, registration number: 176115.

4.1.2 Major principles of valuation

Receivables from the central government

Securities stated under receivables from the central government are recorded in the balance sheet at purchase price and include no interest. The difference between the purchase price excluding interest and the face value is shown in the MNB's income statement as a valuation gain or loss in proportion to the time elapsed.

Receivables from the central government also include any receivables associated with the reimbursement of revaluation reserves.

Impairment losses may not be recorded in connection with receivables from the central government.

Receivables from credit institutions

Mortgage bonds stated under receivables from credit institutions are recorded in the balance sheet at purchase price net of interest. The market value difference at acquisition is shown in the MNB's interest related income as a valuation gain or loss in proportion to the time elapsed.

Impairment losses on mortgage bonds must be accounted in proportion to the risk of losses.

Valuation of foreign currency assets and liabilities and the recording of exchange rate gains

In its books, the MNB records all foreign currency assets and liabilities at the official exchange rate prevailing on the date of acquisition. If a foreign currency asset or liability is created as a result of foreign exchange conversion, the exchange rate gain or loss arising from the difference between the actual rate and the official rate is recorded by the MNB as conversion income for that particular date and is recognised under gains/loss from exchange rate changes in the income statement.

The MNB carries out daily revaluation of foreign currency assets and liabilities as well as off-balance sheet assets and liabilities arising from derivative transactions for hedging purposes, taking account of variations in the official exchange rate. As a result of this revaluation, balance sheet items denominated in foreign currency are stated in an amount converted at the official exchange rate prevailing on 31 December. Banking assets and banking liabilities in foreign currencies (with the exception of foreign investments) and derivative transactions for purposes other than hedging do not form part of revaluation.

Income received in foreign currency is stated at the official exchange rate prevailing on that particular date.

Daily accounting for accrued income is preceded by reversing the accrued income on the previous day. As a result, foreign currency accruals are recorded in the balance sheet at the official exchange rate without revaluation.

In respect of the foreign exchange gains and losses arising in the course of daily revaluation, realised exchange rate gains can be stated as a profit item, while unrealised income is reported under 'Equity', in the item 'Revaluation reserve due to exchange rate changes'.

Realised income arises as a result of selling and buying foreign currency. The latter occurs when the assets in a given currency are exceeded by corresponding liabilities. Realised income arises as the difference between the value of the traded foreign currency at the official exchange rate and the average cost rate.

Foreign currency securities

Foreign currency securities are stated at market price. The difference between the market value prevailing on the date of valuation and the book value is recorded in the revaluation reserve of foreign currency securities as part of equity. Exchange rate gains or losses realised on selling and maturing are stated under 'Realised gains/losses arising from financial operations'.

The Magyar Nemzeti Bank measures its securities on the basis of market prices prevailing on the last working day in December, however if adequately liquid prices are not ensured on this day, the valuation of securities is based on the market prices available on the previous working day.

Securities issued by the MNB abroad and subsequently repurchased must be recognised in gross, i.e. in the item 'Other foreign currency receivables'. Repurchased own-issue foreign currency bonds are measured at historical cost. Interest on repurchased bonds is recorded under both income and expenses.

Security repurchase transactions are recorded as credit/deposit transactions, while the related receivables or liabilities are stated as off-balance sheet items.

Securities lent through securities lending operations based on international agreements need not be removed from foreign exchange reserves; they are recorded as off-balance sheet items. Non-cash collateral and investments from cash collateral must be recorded as contingent liabilities under off-balance sheet items.

Accounting rules relating to the IMF quota

Part of the IMF quota subscribed in foreign currency and denominated in SDR as a callable loan is stated under foreign exchange reserve.

Part of the quota paid in forint, subscribed in SDR, is presented under 'Other foreign currency receivables' in the balance sheet. The related IMF forint deposit is presented on the liabilities side of the balance sheet. It is the MNB's duty to ensure at least annually that the amount of the IMF's forint deposit is equal to the amount of the quota paid in forint. As this deposit account is a HUF account only formally, it is presented under 'Other foreign currency payables' in the balance sheet.

The loan granted by the IMF raises the amount of foreign exchange reserves and the IMF's forint deposit. The disbursement is recorded in the form of a swap transaction, which means HUF receivables and SDR liabilities.

SDR allocation aims to increase the foreign exchange reserves of the IMF's members and creates an unmatured liability vis-à-vis the IMF on the liability side of the balance sheet. This transaction has no effect on profit or loss if it is not utilised.

Accounting rules relating to derivatives

On the basis of transaction purpose, the MNB distinguishes between two groups of derivative transactions: hedging transactions and derivatives transactions for purposes other than hedging.

Hedging transactions are defined as transactions which reduce the risk arising from changes in the exchange rate or market value of a specific asset or liability or position, are directly related to such, are announced as hedging transactions at the start of the deal and fulfil the hedge effectiveness criteria determined by the Act on Accounting. Derivative transactions with the government or non-resident counterparts on behalf of the government are also regarded as hedging transactions.

Derivative transactions must be stated under off-balance sheet assets and liabilities. The aggregate revaluation difference of foreign currency assets and liabilities arising from hedging transactions must be stated in the balance sheet (depending on their balance, either in the item 'Other foreign currency receivables or liabilities', or 'Foreign currency receivables from or liabilities to the central government'), including the interest accrued in proportion to time elapsed (as accrued income or accrued expenses).

When derivative transactions for purposes other than hedging are closed, the income from such transactions must be stated in the lines of income and expenses arising from exchange rate changes when foreign exchange transactions are involved, and in the lines of interest related income and interest related expenses in the case of transactions linked to interest rate changes. While such transactions are not revalued, consistent with the principle of prudence, a quarterly provision is set aside equal to the negative market value of the transaction.

Banking assets and liabilities

Banking assets and liabilities are stated on the respective sides of the balance sheet. These are the following:

- assets and liabilities not directly related to central bank functions and bank operations (such as settlements relating to taxes, contributions, payments to employees, creditors, unsold precious metals held for non-central bank purposes), as well as

- liabilities arising from banknotes no longer accepted as legal tender but not yet exchanged,

- investments, and

- assets required for operating the organisation (such as intangibles, tangibles and inventories).

The MNB's balance sheet does not state cash among liquid assets. The central bank is the exclusive issuer of banknotes and coins. Notes and coins held at the Cashier and the Depository are not in circulation and therefore are deducted from banknotes and coins on the liabilities side of the balance sheet.

Depreciation rates applied by the Magyar Nemzeti Bank

Per cent

Description	31. 12. 2011
Concessions, licences and similar rights	17
Trade-marks patents and similar assets	14.5–50
Capitalized value of reorganization	20
Buildings	3
Vehicles*	20
Telecommunication devices, office equipment, machines	9–50
Office equipment	14.5–33
Computer hardware	9–33
Emission machinery	5–33
Instruments	9–33
Bank security devices	2–33
Other equipment and devices	6.5–33

** Residual value 20 per cent of the vehicles with 5-year time of use.*

The above listed ranges of depreciation rates are reference values based on estimated useful economic life. The Bank must deviate from the reference values depending on the actual time of use. Depreciation is charged on a straight line basis in every case.

4.2 EFFECTS OF MACROECONOMIC TRENDS ON THE 2011 BALANCE SHEET AND INCOME STATEMENT OF THE MAGYAR NEMZETI BANK

The balance sheet and income statement of the Magyar Nemzeti Bank are primarily influenced by the objectives and selected instruments of monetary policy, as well as by domestic and international economic events.

In 2011, the MNB recorded a profit of HUF 13.6 billion. In respect of macroeconomic events, changes in the forint exchange rate exerted the most important influence on the Bank's profit. The official forint exchange rate against the euro fluctuated in a rather wide band during the year; it strengthened in the first half of the year, but then weakened significantly in the second half of the year. The official exchange rate remained close to the average cost rate until June 2011, and was typically weaker in this period, only strengthening above it for a few days. Due to the weakening, which started in the second half of the year and became increasingly intense, the forint exchange rate then departed considerably from the average cost rate and increased the amount of revaluation reserves to a great degree. The difference between the two rates at the end of 2010 was 14.01 forint/euro, increasing to 42.11 forint/euro by 31 December 2011. The total net revaluation effect was a gain of HUF 1,007.7 billion. The revaluation reserve due to exchange rate changes, as an unrealised foreign exchange gain, increased by HUF 909 billion to HUF 1,325 billion by the end of 2011. For most of the year, the volume of foreign currency sales was normal; it was only higher in the fourth quarter with special regard to EUR sales tenders related to the early repayment of foreign exchange mortgage loans. Due to the decrease in the foreign currency position, the MNB realised a gain of HUF 98.7 billion during 2011.

The balance sheet total according to Hungarian Accounting Standards (HAS) was HUF 12,501.8 billion on 31 December 2011, up more than 20 percentage points relative to end-2010. This increase was caused by the rise of the balance of foreign exchange reserves. In 2011, the bank recorded a net interest and interest-related loss of HUF 94 billion, which was a decrease of HUF 40.2 billion relative to the previous year. Net interest income was determined mainly by the increase in the Bank's net foreign currency receivables, which at the same time also resulted in an increase in forint liabilities bearing interest at the central bank base rate. Due to the effect of the rise in the central bank base rate at the beginning of the year, forint and foreign currency interest rates deviated from each other. This interest rate difference declined in the second half of the year, as the increase in the central bank rate implemented in two stages at the end of the year was exceeded by the increase in average foreign currency interest rates. The average central bank base rate was 6.04 per cent in 2011, which was 57 basis points higher than the annual average in 2010.

For more details on impacts on net income, see Section 3.10 of the Business Report.

4.3 FORINT RECEIVABLES FROM THE CENTRAL GOVERNMENT

HUF millions

B/S line	Remaining maturity	Balance		Change
		31. 12. 2010	31. 12. 2011	
	Government bonds maturing within 1 year	35,245	26,289	–8,956
	Government bonds maturing within 1 to 5 years	66,589	4,417	–62,172
	Government bonds maturing over 5 years	147,617	137,795	–9,822
	Government bonds	**249,451**	**168,501**	**–80,950**
	Receivables due to revaluation reserves of foreign currency securities	**29,142**	**0**	**–29,142**
I.1.	**Total receivables from the central government**	**278,593**	**168,501**	**–110,092**

The amount of government bonds recorded at historic cost was HUF 168.5 billion at the end of 2011, a decrease of HUF 81 billion compared to end-2010. During the year there were no new purchases, but one bond matured out of the government bonds purchased by the MNB in the autumn of 2008 in order to support the normal operation of the domestic market of government securities and reinforce the liquidity of the banking sector. The maturity caused a decrease of HUF 33.8 billion in the value of the securities, and the scheduled repayment of an amortising bond (to be repaid annually over five years) resulted in a further decrease of HUF 1.4 billion.

With the goal of protecting the achievements of the mortgage bond programme launched by the MNB in 2010, in a securities swap transaction, HUF government bonds were transferred to the Pension Reform and Debt Reduction Fund by the MNB in exchange for HUF mortgage bonds of the same market value. Because of this transaction the balance of government bonds decreased by HUF 45.7 billion. (see Section 4.7)

Receivables due to the negative balance of revaluation reserves of foreign currency securities amounted to HUF 29.1 billion at the end of 2010; it was reimbursed by the central government on 31 March 2011, pursuant to Article 17, paragraph (4) of the MNB Act, which was valid until 31 December 2011.

The aggregate balance of revaluation reserves due to exchange rate changes and of revaluation reserves of foreign currency securities was positive on 31 December 2011 and therefore receivables from the central government did not arise.

4.4 FOREIGN CURRENCY RECEIVABLES FROM THE CENTRAL GOVERNMENT

HUF millions

B/S line	Description	Balance		Change
		31. 12. 2010	31. 12. 2011	
	Swap transactions with the central government	475	0	–475
	Currency swaps with the central government	1,317	747	–570
II.2.	**Foreign currency receivables from the central government**	**1,792**	**747**	**–1,045**

Swap transactions concluded with the central government at the end of 2010 matured in January 2011.

The HUF 0.7 billion balance of currency swaps with the central government contains currency swaps concluded with the ÁKK before June 2002, in the interests of adjusting the foreign currency and interest structure of foreign debt. The decrease of HUF 0.6 billion compared to the previous year resulted almost all from transactions (from the scheduled repayment of some transaction), and the revaluation effect was insignificant.

Foreign currency receivables from the central government by remaining maturity

HUF millions

B/S line	Remaining maturity	Balance		Change
		31. 12. 2010	31. 12. 2011	
	– within 1 year	1,031	431	–600
	– within 1 to 5 years	761	316	–445
	– over 5 years	0	0	0
II.2.	**Foreign currency receivables from the central government**	**1,792**	**747**	**–1,045**

Currency structure of swaps concluded with the central government

HUF millions

No.	Description	Balance		Change
		31. 12. 2010	31. 12. 2011	
1.	– HUF	203,826	0	–203,826
2.	– EUR currency group*	6,040	3,893	–2,147
3.	**Swap receivables (1+2)**	**209,866**	**3,893**	**–205,973**
4.	– HUF	432	0	–432
5.	– EUR currency group*	91,772	0	–91,772
6.	– JPY	25,788	0	–25,788
7.	– USD	90,082	3,146	–86,936
8.	**Swap payables (4+5+6+7)**	**208,074**	**3,146**	**–204,928**
9.	**Net swap receivables (3–8)**	**1,792**	**747**	**–1,045**

** The EUR currency group includes the euro and other European currencies (such as GBP, CHF) that may be listed here with regard to foreign exchange risk.*

4.5 FORINT AND FOREIGN CURRENCY DEPOSITS OF THE CENTRAL GOVERNMENT

Forint deposits of the central government

HUF millions

B/S line	Description	Balance		Change
		31. 12. 2010	31. 12. 2011	
	Single Treasury Account (KESZ)	272,099	596,607	324,508
	Deposit by Government Debt Management Agency (ÁKK Zrt.)	397	340	–57
	Other	63	63	0
VI.1.	**Forint deposits of the central government (total)**	**272,559**	**597,010**	**324,451**

The balance of forint deposits of the central government was nearly HUF 600 billion at the end of 2011 because of the amount of EU-transfers was higher than it was projected in December, and these transfers were only allocated in 2012.

Foreign currency deposits of the central government

The balance of the foreign currency liabilities of the central government amounted to HUF 786 billion on 31 December 2011, a decrease of HUF 18.2 billion compared to the end of 2010.

The expiry dates of all central government foreign currency deposits are within a year; the total amount of deposits decreased slightly compared to 31 December 2010. The average amount of foreign currency deposits in 2011 was HUF 185.5 billion (22.2 per cent) higher relative to the previous year.

4.6 NET POSITIONS VIS-À-VIS THE CENTRAL GOVERNMENT

HUF millions

B/S line	Description	Balance		Change
		31. 12. 2010	31. 12. 2011	
I.1.–VI.1.	Net forint position	6,034	–428,509	–434,543
II.2.–VII.1.	Net foreign currency position	–802,424	–785,301	17,123
	Total	**–796,390**	**–1,213,810**	**–417,420**

4.7 FORINT RECEIVABLES FROM CREDIT INSTITUTIONS

HUF millions

B/S line	Description	Balance		Change
		31. 12. 2010	31. 12. 2011	
	Security-backed loans	0	35,000	35,000
	Covered mortgage bonds	36,293	85,580	49,287
	Total receivables from credit institutions in gross value	**36,293**	**120,580**	**84,287**
	Impairment loss for covered mortgage bonds	–1,252	–1,939	–687
I.2.	**Total receivables from credit institutions**	**35,041**	**118,641**	**83,600**

The end-2011 balance of security-backed loans only includes loans maturing within one year and amounted to HUF 35 billion. This balance is derived from two-week and six-month loan tenders drawn by individual banks in order to eliminate their forint liquidity shortages.

Receivables in connection with mortgage bonds increased by HUF 49.3 billion and amounted to HUF 85.6 billion on 31 December 2011. This value represents the balance of receivables in a gross value, which contains the cost price difference besides the face value. The MNB started a mortgage bond buying programme in March 2010 and within the framework of this activity it was able to purchase mortgage bonds both in the primary and secondary market. The stock of mortgage bonds was HUF 36.3 billion at the end of 2010, from which three bonds matured in the first quarter of 2011, amounting to HUF 2.6 billion in total. In the interests of preserving the achievements of the programme, on 23 December 2011 the MNB received mortgage bonds from the Pension Reform and Debt Reduction Fund and in exchange for them transferred HUF government bonds at the same price (see Section 4.3). Due to the exchange, the balance of mortgage bonds rose by HUF 51.9 billion. The Fund used the government bonds transferred in the transaction to reduce public debt. The mortgage bonds received by the MNB are treated in the same manner as the mortgage bonds purchased during its mortgage bond programme; they are qualified as securities held for monetary purpose. As these are not government bonds, however, in the case of bond's market price falling below the purchase price, an impairment loss must be recorded on the mortgage bonds at the end of the year, as set forth in the MNB Decree. Due to the year-end qualification of receivables, from the impairment losses created for mortgage bonds in 2010 HUF 0.1 billion were released, owing to maturity or improvement in market price, while due to depreciation in market price additional impairment losses of HUF 0.8 billion were recorded. Thus, the net amount of impairment losses due to mortgage bonds increased by HUF 0.7 billion to HUF 1.9 billion by end-2011.

Forint receivables from credit institutions by remaining maturity

HUF millions

No.	Remaining maturity	Balance		Change
		31. 12. 2010	31. 12. 2011	
1.	– within 1 year	2,627	54,458	51,831
2.	– within 1 to 5 years	33,666	55,912	22,246
3.	– over 5 years	0	10,210	10,210
4.	**Total receivables from credit institutions in gross value (1+2+3)**	**36,293**	**120,580**	**84,287**

4.8 NET POSITIONS VIS-À-VIS CREDIT INSTITUTIONS

HUF millions

B/S line	Description	Balance		Change
		31. 12. 2010	31. 12. 2011	
I.2.–VI.2.	Net forint position	–795,559	–1,198,939	–403,380
II.3.–VII.2.	Net foreign currency position	–23,699	5,080	28,779
	Total	**–819,258**	**–1,193,859**	**–374,601**

Net liabilities to credit institutions increased HUF 374.6 billion by 31 December 2011. The net forint position deteriorated by HUF 403.4 billion compared to the previous year, and the amount of net forint liabilities was near HUF 1,200 billion at 31 December 2011. The one-day deposits of credit institution played an important role in net forint liabilities; the balance of deposits rose by HUF 509.6 billion to HUF 941.8 billion by the end of 2011. The effect of this deposit-taking on position was slightly offset by receivables in connection with the MNB's mortgage bond exchange programme. The net foreign currency position turned into net receivables amounting to HUF 5.1 billion by end-2011, compared to end-2010 when the net position was net liabilities of HUF 23.7 billion. The end-2011 net position fully included the net swap receivables, as there were no short-term money market foreign currency deposits with the MNB placed by credit institutions at the end of 2011. There was no balance on the STEP2 accounts as at 31 December 2011, because these accounts ceased to exit in 2011.

4.9 GOLD AND FOREIGN EXCHANGE RESERVES OF THE CENTRAL BANK

Forint balances

HUF millions

B/S line	Description	Balance		Change
		31. 12. 2010	31. 12. 2011	
	Gold reserve	29,071	37,153	8,082
	Reserve position in the IMF	23,725	27,196	3,471
	Foreign currency deposits	820,390	1,523,122	702,732
	Foreign currency securities	8,316,634	9,455,887	1,139,253
	Foreign currency repo transactions	90,553	561,156	470,603
II.1.	**Gold and foreign currency reserves (total)**	**9,280,373**	**11,604,514**	**2,324,141**

For statistical purposes, the MNB regularly publishes the amount of gold and foreign currency reserves. According to the statistical rules, foreign currency reserves also include accrued interest; consequently, gold and foreign currency reserves differ in amount according to statistical and accounting rules.

Foreign exchange reserves not including accrued interest rose by HUF 2,324.1 billion to HUF 11,604.5 billion as at 31 December 2011. The change was caused both by the rise in balances and by depreciation of the exchange rate.

Euro balances

EUR millions

B/S line	Description	Balance		Change
		31. 12. 2010	31. 12. 2011	
	Gold reserve	104	119	15
	Reserve position in the IMF	85	87	2
	Foreign currency deposits	2,943	4,896	1,953
	Foreign currency securities	29,835	30,392	557
	Foreign currency repo transactions	325	1,804	1,479
II.1.	**Gold and foreign currency reserves (total)**	**33,292**	**37,298**	**4,006**

The official exchange rate of the forint was EUR/HUF 278.75 on 31 December 2010 and EUR/HUF 311.13 on 31 December 2011.

The main causes of the increase in the amount of gold and foreign currency reserves were the foreign currency arising from Hungarian government securities issued by ÁKK in the first half of the year, and from the development credit granted by European Investment Bank, as well as net EU transfers and market yields of the reserves. Both the maturities of two foreign exchange bonds issued earlier by ÁKK and of the credit provided by the European Commission in 2008 reduced the level of gold and foreign currency reserves, as did the foreign exchange outflow to the banking system in the course of euro-sales tenders related to the early repayment of foreign exchange mortgage loans granted to households; payments by the MNB in connection with own debt management, and foreign currency conversion performed by the Hungarian State Treasury not related to debt-financing. As a consequence of the aforementioned effects, the stock of gold and foreign exchange reserves denominated in euro increased by EUR 4 billion as at 31 December 2011.

4.10 OTHER FOREIGN CURRENCY RECEIVABLES

HUF millions

B/S line	Description	Balance		Change
		31. 12. 2010	31. 12. 2011	
	Forint payment of IMF quota	309,944	355,288	45,344
	Repurchased bonds	73,282	39,967	−33,315
	Foreign hedging transactions*	11,859	0	−11,859
	Other	966	1,420	454
II.4.	**Other foreign currency receivables**	**396,051**	**396,675**	**624**

** The revaluation difference of hedging derivative transactions is stated in net terms, in accordance with the MNB Decree.*

The forint payment of the IMF quota increased due to the depreciation of the forint exchange rate in comparison to SDR by 14.6 per cent.

The amount of bonds issued abroad by the MNB and subsequently repurchased decreased by HUF 39.1 billion owing to January maturities, but due to the depreciation of the forint exchange rate versus the Japanese yen and the US dollar, the year-end balance increased by HUF 5.8 billion.

The item 'Foreign hedging transactions' includes the over one-year credit balance of currency swap transactions with non-resident counterparties concluded by the MNB in 2010, while due to the total balance of these transactions they were transferred to the liabilities side of the balance sheet in 2011.

4.11 OTHER DEPOSITS AND LIABILITIES

Other forint liabilities

HUF millions

B/S line	Description	Balance		Change
		31. 12. 2010	31. 12. 2011	
	Two-week MNB bills	3,024,699	3,403,292	378,593
	International financial institutions forint deposits	11,958	4,460	−7,498
	Other liabilities	675	14,611	13,936
VI.4.	**Other forint deposits and liabilities**	**3,037,332**	**3,422,363**	**385,031**

The end-of-2011 balance of other forint deposits and liabilities showed an increase of HUF 385 billion (12.7 per cent) compared to the previous year-end; which was almost completely due to the rise in the amount of two-week MNB bills. The two-week MNB bill is the most important monetary policy instrument of the MNB. The issue yield on bills is equal to the prevailing central bank base rate.

Other foreign currency liabilities

HUF millions

B/S line	Description	Balance		Change
		31. 12. 2010	31. 12. 2011	
	Bonds	169,990	79,187	–90,803
	Repo transactions	1,091,864	963,259	–128,605
	IMF forint deposit	1,010,503	1,084,749	74,246
	Foreign deposits and loans	39,073	18,509	–20,564
	Hedging transactions*	24,785	114,398	89,613
	Other liabilities	783	362	–421
VII.3.	**Other foreign currency liabilities**	**2,336,998**	**2,260,464**	**–76,534**

** The revaluation difference of hedging transactions is stated in net terms, in accordance with the MNB Decree.*

The balance of other foreign currency liabilities declined by HUF 76.5 billion to HUF 2,260.5 billion as at 31 December 2011. One of the bonds issued abroad by the MNB matured in January, amounting to JPY 40 billion in face value, and thus due to the maturity and the revaluation effect the balance of bonds declined by HUF 90.8 billion. The decrease of HUF 128.6 billion of foreign currency liabilities resulted from repo transactions due to transactions effect. Repo transactions concluded with the ECB formed a significant part of the end-of-year repo transactions, of which the existing balance was EUR 1.8 billion at the end of 2010 and EUR 1.5 billion at the end of 2011. The year-end balance of the IMF forint deposit rose by HUF 74.2 billion due to revaluation. The item 'Hedging transactions' mainly includes the net liabilities of the IMF-swap, which are related to the IMF loan and of the over one-year currency swap transactions with non-resident counterparties concluded by the MNB.

Other foreign currency liabilities by remaining maturity

HUF millions

B/S line	Remaining maturity	Balance		Change
		31. 12. 2010	31. 12. 2011	
	– within 1 year	1,926,943	1,728,487	–198,456
	– within 1 to 5 years	91,600	166,933	75,333
	– over 5 years	318,455	365,044	46,589
VII.3.	**Other foreign currency liabilities**	**2,336,998**	**2,260,464**	**–76,534**

Currency structure of other foreign currency liabilities (excluding hedging transactions)

HUF millions

No.	Description	Balance		Change
		31. 12. 2010	31. 12. 2011	
1.	– USD	48,232	57,979	9,747
2.	– EUR currency group*	1,124,742	972,287	–152,455
3.	– JPY	128,260	31,051	–97,209
4.	– SDR	318,455	365,044	46,589
5.	– Other	692,524	719,705	27,181
6.	**Other foreign currency liabilities**	**2,312,213**	**2,146,066**	**–166,147**

** The EUR currency group includes the euro and other European currencies (such as GBP, CHF) that may be listed here with regard to foreign exchange risk.*

The item 'Other' amounted to HUF 719.7 billion at the end of 2011 and mainly contains the forint coverage of the IMF quota, which accounted for HUF 642.4 billion.

Currency structure of hedging transactions vis-à-vis non residents

HUF millions

No.	Description	Balance		Change
		31. 12. 2010	31. 12. 2011	
1.	– USD	46,743	103,928	57,185
2.	– EUR currency group*	117,149	328,479	211,330
3.	– JPY	139,111	98,589	–40,522
4.	– Other	382,104	364,417	–17,687
5.	**Hedging transactions receivables (1+2+3+4)**	**685,107**	**895,413**	**210,306**
6.	– USD	0	190,042	190,042
7.	– EUR currency group*	303,570	330,715	27,145
8.	– JPY	0	23,288	23,288
9.	– SDR	406,322	465,766	59,444
10.	**Hedging transactions payables (6+7+8+9)**	**709,892**	**1,009,811**	**299,919**
11.	**Net hedging transactions payables (10–5)**	**24,785**	**114,398**	**89,613**

** The EUR currency group includes the euro and other European currencies (such as GBP, CHF) that may be listed here with regard to foreign exchange risk.*

4.12 NET POSITION VIS-À-VIS THE IMF

HUF millions

B/S line	Description	Balance		Change
		31. 12. 2010	31. 12. 2011	
from II.1.	IMF quota paid in SDR	23,725	27,196	3,471
from II.1.	Deposit with IMF	240,882	202,047	–38,835
from II.1.	Deposit with IMF for Fund's programme purposes	2,968	3,403	435
from II.4.	IMF quota paid in HUF	309,944	355,288	45,344
	Total receivables	**577,519**	**587,934**	**10,415**
from VII.3.	Liabilities arising from SDR Allocations	318,454	365,044	46,590
from VII.3.	IMF No. 2. account	1	1	0
from VII.3.	IMF No. 1. account	692,048	719,705	27,657
from VII.3.	Swap receivables from IMF	–382,104	–364,417	17,687
from VII.3.	Swap payables to IMF	406,322	465,766	59,444
	Total liabilities	**1,034,721**	**1,186,099**	**151,378**
	Total	**–457,202**	**–598,165**	**–140,963**

The IMF loan amounting to SDR 1.3 billion was drawn down by the MNB in 2009. According to the IMF's regulations, disbursement is recorded in the form of a swap transaction, which means forint receivables and SDR liabilities. This swap transaction appeared on the liability side due to revaluations in 2011: the amount of forint receivables is determined by the IMF, and the volume of liabilities depends on the foreign exchange rate of SDR. The liability from the IMF is shown in the item 'Swap payables to IMF' of the table and amounted to HUF 465.8 billion as at 31 December 2011. The loan granted by the IMF raises the amount of foreign exchange reserves and the balance of the IMF No. 1. account on the liability side (i.e. forint coverage of the IMF quota).

The item 'Liabilities arising from SDR allocations' represents the unmatured liability of HUF 365 billion (i.e. SDR 991.1 million) arising from the allocation distributed by the IMF in 2009 on the one hand. This amount raised the deposit with the IMF on the other hand. The SDR allocation may be used for repaying the capital amount and interest of the loan from the IMF. The allocation was appropriated for interest payment in 2011.

The HUF-denominated promissory note related to the liability from the Fund disbursements of the Hungarian State and placed with the MNB as a fiscal agent is shown as an off-balance sheet item in the balance sheet of the MNB (see Section 4.18.). The commitment amounted to HUF 1,925.6 billion at 31 December 2010 and had decreased to HUF 1,836.5 billion at 31 December 2011, as a result of exchange rate changes.

4.13 INVESTED ASSETS

In addition to intangibles, tangibles and capital expenditure (HUF 15 billion), invested assets include shares in investments (HUF 8.9 billion in foreign investments and HUF 10.6 billion in domestic investments).

Changes in the gross value, depreciation and net value of intangibles, tangibles and capital expenditure

HUF millions

	Assets						Intangibles, tangibles and capital expenditure, total
	Immaterial goods		Tangible assets			Capital expenditure and advances given	
	Intangible assets	Software under development	Buildings	Equipment	Assets of banknote and coin		
Gross value							
31. 12. 2010	**7,701**	**22**	**12,383**	**10,867**	**230**	**208**	**31,411**
Installation/repurchases	338	9	30	589	10	–196	780
Other addition	7	0	0	0	0	0	7
Scrapping	–197	0	0	–216	0	0	–413
Selling	0	0	0	–135	0	0	–135
Transfer free of charge	0	0	–383	–269	0	0	–652
Other disposal/reclassification	–4	0	0	–4	–5	0	–13
31. 12. 2011	**7,845**	**31**	**12,030**	**10,832**	**235**	**12**	**30,985**
Details of depreciation							
31. 12. 2010	**6,331**	**0**	**2,265**	**6,592**	**0**	**0**	**15,188**
Planned depreciation	490	0	384	927	0	0	1,801
Removal from the account	–201	0	–175	–617	0	0	–993
Decrease due to reclassification	0	0	0	0	0	0	0
31. 12. 2011	**6,620**	**0**	**2,474**	**6,902**	**0**	**0**	**15,996**
Balance							
31. 12. 2010	**1,370**	**22**	**10,118**	**4,275**	**230**	**208**	**16,223**
31. 12. 2011	**1,225**	**31**	**9,556**	**3,930**	**235**	**12**	**14,989**
Change	**–145**	**9**	**–562**	**–345**	**5**	**–196**	**–1,234**

Foreign investments and dividends from investments

HUF millions

Description	Ownership share (%)		Book value		Dividends received*	
	31. 12. 2010	31. 12. 2011	31. 12. 2010	31. 12. 2011	2010	2011
BIS	1.43	1.43	6,225	7,144	1,967	740
SDR millions			*10*	*10*		
CHF millions			*13.5*	*13.5*		
European Central Bank	1.39	1.39	1,559	1,739	0	0
EUR thousands			*5,591*	*5,591*		
SWIFT	0.02	0.02	2	3	0	0
EUR thousands			*8.6*	*8.6*		
Total investments			**7,786**	**8,886**	**1,967**	**740**

** Dividends financially settled in the given year.*

The Republic of Hungary joined the European Union on 1 May 2004. Consequently, the MNB became a member of the ESCB. The ESCB comprises the European Central Bank (ECB) and the national central banks of the 27 EU Member States. The Eurosystem comprises the ECB and the national central banks of Member States which have already adopted the euro.

Pursuant to the provisions of Article 28 of the Statute of the ESCB and the ECB (hereinafter referred to as 'the Statute'), the MNB has become a subscriber to the capital of the ECB.

Ownership distribution in the ECB at 31 December 2011

National Central Banks (NCBs)	Subscribed capital	Paid-up capital	Capital key (%)
	EUR thousands		
Nationale Bank van België / Banque Nationale de Belgique	261,010	220,584	2.4256
Deutsche Bundesbank	2,037,777	1,722,155	18.9373
Eesti Pank	19,262	16,278	0.1790
Bank of Greece	211,436	178,688	1.9649
Banco de España	893,565	755,165	8.3040
Banque de France	1,530,294	1,293,274	14.2212
Central Bank and Financial Services Authority of Ireland	119,518	101,007	1.1107
Banca d'Italia	1,344,716	1,136,439	12.4966
Central Bank of Cyprus	14,731	12,450	0.1369
Banque centrale du Luxemburg	18,799	15,887	0.1747
Central Bank of Malta / Bank Centrali ta' Malta	6,801	5,747	0.0632
De Nederlandsche Bank	429,156	362,686	3.9882
Österreichische Nationalbank	208,940	176,578	1.9417
Banco de Portugal	188,354	159,181	1.7504
Banka Slovenije	35,381	29,901	0.3288
Národná banka Slovenska	74,614	63,058	0.6934
Suomen Pankki – Finlands Bank	134,928	114,029	1.2539
Subtotal for euro area NCBs	**7,529,282**	**6,363,107**	**69.9705**
Danmarks Nationalbank	159,634	5,986	1.4835
Sveriges Riksbank	242,997	9,112	2.2582
Bank of England	1,562,146	58,581	14.5172
Česká národní banka	155,728	5,840	1.4472
Latvijas Banka	30,528	1,145	0.2837
Lietuvos bankas	45,797	1,718	0.4256
Magyar Nemzeti Bank	149,100	5,591	1.3856
Narodowy Bank Polski	526,777	19,754	4.8954
Bulgarian National Bank	93,467	3,505	0.8686
Banca Naţională a României	265,196	9,945	2.4645
Subtotal for non-euro area NCBs	**3,231,370**	**121,177**	**30.0295**
Total NCBs	**10,760,652**	**6,484,284**	**100.0000**

The sub-item 'Invested assets' among 'III. Banking assets' in the balance sheet of the MNB represents the MNB's participation in the ECB. Subscriptions depend on shares which are fixed in accordance with Article 29.3 of the Statute and which must be adjusted every five years. Based on demographic and GDP data provided by the European Commission, Hungary's share in the ECB's capital was 1.3884 per cent, i.e. EUR 77.3 million at the time of accession. Shares can change in two ways: with a new accession to the EU or with the adjustment of capital key implemented every five years. As a result of the adjustment, the MNB's capital key changed to 1.3856 per cent i.e. EUR 79.8 million as of 1 January 2009.

Effective 29 December 2010, the ECB's subscribed capital increased by EUR 5 billion to 10,761 million, and thus Hungary's share in the ECB's capital rose to EUR 149.1 million, while the capital key remained unchanged. The measure of the contribution to the ECB's operational cost to be paid up by non-euro area NCBs changed as well; 3.75 per cent of their share in the subscribed capital of the ECB shall be paid instead of the earlier 7 per cent, pursuant to Article 47 of the Statute. The value of the investment amounted to EUR 5.6 million in the MNB's balance sheet as at 31 December 2011.

Since 1 January 2011 the legal tender of Estonia has been the euro, and thus Eesti Pank now constitutes one of the euro-area NCBs.

On 1 July 2004, the Magyar Nemzeti Bank undertook participation in the London-based CEBS Secretariat Ltd. established under UK law to provide, pursuant to its deed of foundation, administrative services to the Committee of European Banking Supervisors. Members contribute their respective quotas to its operating costs according to an annual payment schedule. As membership required the investment of a mere GBP 1, it is not recorded in the MNB's books. The activities of CEBS will be taken over by the European Banking Authority from 2011, in which Hungary is represented by the Hungarian Financial Supervisory Authority. The MNB participates as an observer.

Domestic investments and dividends from investments

HUF millions

Description	Ownership share (%)		Book value		Dividends received*	
	31. 12. 2010	31. 12. 2011	31. 12. 2010	31. 12. 2011	2010	2011
Pénzjegynyomda Zrt. 1055 Budapest, Markó utca 17.	100.0	100.0	8,927	8,927	1,688	897
Magyar Pénzverő Zrt. 1239 Budapest, Európa u. 1.	100.0	100.0	575	575	811	415
KELER Zrt. 1075 Budapest, Asbóth utca 9–11.	53.3	53.3	643	643	0	0
KELER KSZF Zrt.** 1075 Budapest, Asbóth utca 9–11.	13.6	13.6	7	62	0	0
GIRO Elszámolásforgalmi Zrt. 1054 Budapest, Vadász utca 31.	7.3	7.3	46	46	132	121
Budapesti Értéktőzsde Zrt. 1062 Budapest, Andrássy út 93.	6.9	6.9	321	321	96	90
Total investments			**10,519**	**10,574**	**2,727**	**1,523**

** Dividends financially settled in the given year.*
*** KELER KSZF Kft. was transformed into private limited company by the court of registry's registration on 17 March 2011.*

Key indicators of domestic investments (preliminary data*)

HUF millions

Investment	Share capital	Reserves	Profit/loss for the year	Equity	Profit/loss for the year after taxation
	31. 12. 2011	31. 12. 2011	31. 12. 2011	31. 12. 2011	2011
Pénzjegynyomda Zrt.	8,927	83	243	9,253	243
Magyar Pénzverő Zrt.	575	346	75	996	360
KELER Zrt.	4,500	13,453	1,569	19,522	1,743
KELER KSZF Zrt.**	20	439	195	654	195
GIRO Elszámolásforgalmi Zrt.	2,496	3,615	1,262	7,373	1,262
Budapesti Értéktőzsde Zrt.	541	4,900	1,125	6,566	1,125

** Upon compilation of the Annual Report these are the latest data and in the case of affiliated firms with 100 per cent ownership audited data.*
*** The data 'Profit/loss for the year' refers to the period from 1 April 2011 to 31 December 2011.*

HUF millions

Investment	Net sales revenue		Financial income		Other income		Extraordinary income	
	2010	2011	2010	2011	2010	2011	2010	2011
Pénzjegynyomda Zrt.	7,752	5,183	286	103	19	166	0	0
Magyar Pénzverő Zrt.	3,556	3,350	41	28	4	7	0	0
KELER Zrt.	n. a.	n. a.	9,263	11,549	257	296	0	0
KELER KSZF Zrt.**	636	506	141	250	0	1	0	0
GIRO Elszámolásforgalmi Zrt.	n. a.	n. a.	4,641	4,400	1,320	1,339	0	0
Budapesti Értéktőzsde Zrt.	3,397*	3,074*	106	118	13	10	0	0

n. a.: revenue is not applicable data.
** Income from Stock Exchange related activities.*
*** The data of KELER KSZF Zrt. refer to the period from 1 April 2011 to 31 December 2011.*

Investment	Average number of staff	
	31. 12. 2010	31. 12. 2011
Pénzjegynyomda Zrt.	419	335
Magyar Pénzverő Zrt.	38	38
KELER Zrt.	113	128
KELER KSZF Zrt.	0	0
GIRO Elszámolásforgalmi Zrt.	128	128
Budapesti Értéktőzsde Zrt.	59	59

The MNB's receivables from and liabilities to affiliated companies

HUF millions

Investment	Receivables	Liabilities
Pénzjegynyomda Zrt.	0	39
Magyar Pénzverő Zrt.	202	0
KELER Zrt.	0	3
KELER KSZF Zrt.	0	0
GIRO Elszámolásforgalmi Zrt.	0	0
Budapesti Értéktőzsde Zrt.	0	0
Total	**202**	**42**

The above table presents short-term receivables and liabilities.

In addition to banknotes, **Pénzjegynyomda Zrt.** produces documents, tax stamps and securities, primarily for institutional clients. Developments were implemented to ensure the secure production of banknotes. With adoption of the euro, the production of forint banknotes will be terminated and, according to the decision of the MNB, Pénzjegynyomda Zrt. will not produce euro banknotes. This may result in potential, but presently unquantifiable losses for the MNB, and consequently the Bank has not recognised an impairment loss on the investment.

Pursuant to the MNB's order, the primary duty of **Magyar Pénzverő Zrt.** is to produce circulation coins for cash turnover and commemorative coins issued by the MNB. Utilisation of the company's free capacity allows the production of non-legal tender commemorative coins and coins for foreign markets on the basis of its own coin programme and for customised orders. Within the range of its commercial activities, the company sells commemorative coins, collector banknotes, medals and gold investment products inland and abroad as a wholesaler and retailer as well.

KELER KSZF Kft. was transformed into private limited company by the court of registry's registration on 17 March 2011. Upon commencement of operations, the equity of **KELER KSZF Zrt.** was HUF 459 million according to the final statement of assets and liabilities of the business association undergoing transformation. The MNB's rate of equity remained unchanged (13.6 per cent), but the company's participation from equity rose to HUF 62 million.

4.14 IMPAIRMENT LOSSES AND PROVISIONS

HUF millions

B/S line	Description	31. 12. 2010	Interim changes in 2011		31. 12. 2011
		Impairment losses / provisions	Increase (+)	Reversal (–)	Total impairment losses / provisions
1	2	3	4	5	3+4+5
from I.2.	Forint receivables from credit institutions	1,252	841	–154	1,939
from II.4.	Other foreign currency receivables	0	141	0	141
from III.	Other assets	20	0	–2	18
VIII.	Liabilities	3,352	1,764	–950	4,166
	– derivatives	234	167	–234	167
	– bond lending	3,118	1,597	–716	3,999
	Total	**4,624**	**2,746**	**–1,106**	**6,264**

Impairment losses and provisions increased by HUF 1,640 million to HUF 6,264 million in 2011.

For the mortgage bonds bought for monetary purposes shown in the item 'Receivables from credit institutions' a net amount of HUF 687 million was recorded as additional impairment losses, due to the fact that the market value of the bonds was lower than their book value; thus the amount of impairment losses increased to HUF 1,939 million.

The entire amount of the provision for the negative market value of derivatives for purposes other than hedging created at the end of 2010 was released owing to maturity of transactions. Provisions amounting to HUF 167 million were created due to the negative market value of the open transactions on 31 December 2011.

According to the international securities lending contracts, the MNB is charged by the entire amount of the potential losses arising from cash-hedge investments made by agents. Based on the principle of prudence, a provision must be created to cover this loss as a future liability. Up to the end of 2011 additional provisions of HUF 881 million became necessary, but at the same time HUF 927 million in provisions created in 2010 was released in the course of the year owing to maturity of some securities or improved market valuations.

4.15 PREPAID EXPENSES/ACCRUED INCOME AND ACCRUED EXPENSES/DEFERRED INCOME

HUF millions

B/S line	Description	Balance		Change
		31. 12. 2010	31. 12. 2011	
	Due to banking transactions	143,523	172,292	28,769
	Due to internal operation	110	616	506
IV.	**Prepaid expenses/accrued income**	**143,633**	**172,908**	**29,275**
	Due to banking transactions	21,917	15,223	–6,694
	Due to internal operation	1,003	861	–142
X.	**Accrued expenses/deferred income**	**22,920**	**16,084**	**–6,836**

Prepaid expenses, accrued income, accrued expenses and deferred income include interest received/charged and interest related income/charges and expenses incurred in the reporting period, independently of the date of financial settlement.

4.16 CHANGES IN EQUITY

HUF millions

B/S line	Description	31. 12. 2010	Interim changes	31. 12. 2011
XI.1.	Share capital	10,000	0	10,000
XI.2.	Retained earnings	75,003	−41,577	33,426
XI.3.	Valuation reserves	0	0	0
XI.4.	Revaluation reserves due to exchange rate changes	415,937	909,026	1,324,963
XI.5.	Revaluation reserves of foreign currency securities	0	5,593	5,593
XI.6.	Profit/Loss for the year	−41,577	55,175	13,598
XI.	**Equity**	**459,363**	**928,217**	**1,387,580**

The share capital consists of a single registered share with a nominal value of HUF 10 billion.

Pursuant to the MNB Act coming into force as from 1 January 2012, the MNB's dividend is specified by the executive board. According to the decision of the executive board, in 2012 the MNB will not pay any dividend from retained earnings for the year 2011.

For more details on revaluation reserves, see Section 4.17.

4.17 REVALUATION RESERVES

HUF millions

B/S line	Description	31. 12. 2010	31. 12. 2011	Change
XI.4.	Revaluation reserves due to exchange rate changes	415,937	1,324,963	909,026
XI.5.	Revaluation reserves of foreign currency securities*	0	5,593	5,593
	Total revaluation reserves	**415,937**	**1,330,556**	**914,619**

** The end-2010 balance on the revaluation reserves of foreign currency securities indicated a loss of HUF 29,142 million, which the central government reimbursed by 31 March 2011.*

The official forint exchange rate versus the euro fluctuated in a range between 262.7 and 316.24 in 2011. The exchange rate strengthened in the first and second quarters and weakened significantly in the third quarter. This tendency continued in the fourth quarter due to the effect of global and country-specific factors. As at 31 December 2011, the forint had weakened by 11.62 per cent to EUR/HUF 311.13, compared to 2010. The average cost rate also rose by HUF 4.28 to EUR/HUF 269.02. The revaluation reserves due to exchange rate changes, calculated as the difference of foreign exchange items converted into forint using the official and average cost rate, increased by HUF 909 billion to HUF 1,325 billion.

Revaluation reserves of foreign currency securities is calculated as the difference between the market value and the book value of securities. In 2010, the negative balance of unrealised losses on foreign currency securities of HUF 29.1 billion was reimbursed by the central government by 31 March 2011. Due to the effects of yield changes on the market, unrealised gains on foreign currency securities of MNB's portfolio showed a positive balance of HUF 5.6 billion.

The MNB Act entering into force as of 1 January 2012 changed the previous regulation on the reimbursement of revaluation reserves and prescribed the implementation of the new rules for the 2011 financial statements. In past years, the central government has had to reimburse the losses, if the balance of either revaluation reserve was negative on the balance sheet date. As of 2011, the balances of revaluation reserves must be summarised and if the joint balance of the revaluation reserves is negative and it also exceeds the joint, positive balance of retained earnings and profit or loss for the year, then the central government must reimburse this negative balance.

Annual changes in the forint exchange rate

forint/euro

Date	MNB official exchange rate	Average cost rate
31. 12. 2010	278.75	264.74
31. 12. 2011	311.13	269.02
Annual depreciation		
In 2010	2.9%	
In 2011	11.6%	

4.18 OFF-BALANCE SHEET LIABILITIES OF THE MNB AND OTHER SIGNIFICANT OFF-BALANCE SHEET ITEMS

Liabilities arising from hedging transactions and related receivables

HUF millions

No.	Description	31. 12. 2010			31. 12. 2011		
		Receivables	Liabilities	Net market value	Receivables	Liabilities	Net market value
1.	Interest rate swap transaction	335,996	335,996	5,351	272,785	272,785	−1,824
2.	CDS transaction	11,150	11,150	489	0	0	0
3.	Interest rate future transaction	0	723,213	−1,473	0	1,262,719	−6,750
4.	**Total hedging transaction (1+2+3)**	**347,146**	**1,070,359**	**4,367**	**272,785**	**1,535,504**	**−8,574**

The aim of interest rate swap transactions for hedging purposes linked to the specific bond issuance is to achieve the interest structure deemed desired by the MNB.

Some of the interest rate swap transactions have been concluded with ÁKK and serve to limit the interest rate risks of foreign exchange rate debt. These are hedged by the MNB through reverse transactions on the capital market.

The aim of interest rate future transactions with a maximum one-year maturity is to protect against an increase in yields on securities in the MNB's portfolio and foreign government bonds.

Liabilities arising from other forward transactions

HUF millions

No.	Description	12. 31. 2010		12. 31. 2011	
		Balance	Market value	Balance	Market value
1.	CDS transaction	0	0	230,236	2,653
2.	Options	1,463	4	320	0
3.	Swap transaction	66,900	1,380	0	0
4.	**Total other forward transactions (1+2+3)**	**68,363**	**1,384**	**230,556**	**2,653**

Under the item 'CDS transaction' (Credit Default Swap) transactions are recorded, the aim of which is to decrease the credit risk of six securities. The transactions will mature in 2012 and in 2016.

Under the item 'Options' one long call option was recorded.

Liabilities from derivative transactions by remaining maturity

HUF millions

No.	Remaining maturity	Balance		Change
		31. 12. 2010	31. 12. 2011	
	– within 1 year	912,520	1,272,053	359,533
	– within 1 to 5 years	152,264	257,228	104,964
	– over five years	5,575	6,223	648
1.	**Hedging transactions**	**1,070,359**	**1,535,504**	**465,145**
	– within 1 year	1,463	4,987	3,524
	– within 1 to 5 years	66,900	225,569	158,669
	– over five years	0	0	0
2.	**Other forward transactions**	**68,363**	**230,556**	**162,193**
3.	**Total (1+2)**	**1,138,722**	**1,766,060**	**627,338**

Other off-balance sheet liabilities

HUF millions

No.	Description	Balance		Change
		31. 12. 2010	31. 12. 2011	
1.	IMF security deposit account	1,925,628	1,836,493	–89,135
2.	Guarantees	1,332	1,534	202
3.	Other off-balance sheet liabilities	2	3	1
4.	**Total (1+2+3)**	**1,926,962**	**1,838,030**	**–88,932**

The IMF security deposit account includes the HUF-denominated promissory note issued by the Hungarian State for the IMF and held by the MNB as bailment (see Section 4.12).

The item 'Guarantees' consists of export guarantees, to which an irrevocable indemnity bond is always linked. When exercising a guarantee, the MNB has the right to a reverse guarantee if needed. In 2011, the balance of guarantees was unchanged, but the value of the guarantees increased as a consequence of exchange rate changes.

Other off-balance sheet liabilities by remaining maturity

HUF millions

No.	Remaining maturity	Balance		Change
		31. 12. 2010	31. 12. 2011	
	– within 1 year	1,305	760,706	759,401
	– within 1 to 5 years	1,925,657	1,077,324	–848,333
	– over five years	0	0	0
1.	**Total other liabilities**	**1,926,962**	**1,838,030**	**–88,932**

Recording off-balance sheet security transactions

HUF millions

No.	Description	Balance		Change
		31. 12. 2010	31. 12. 2011	
1.	Face value of securities lent	883,386	1,059,329	175,943
2.	Purchase cost of the non-cash hedge arising from security lending transactions	103,069	263,615	160,546
3.	Investment of cash hedge arising from security lending transactions			
	– at purchase cost	763,631	740,555	–23,076
	– at market value	760,513	736,556	–23,957
4.	Face value of securities bought under repo transactions	88,720	520,689	431,969
5.	Face value of securities sold under reverse repo transactions	1,163,349	1,440,554	277,205

Regarding the securities bought under repo transactions, see Section 4.11.

4.19 NET INTEREST INCOME AND REALISED NET INCOME OF FINANCIAL OPERATIONS

Net forint and foreign currency interest and interest related income

HUF millions

P/L line	Description	2010	2011	Change
1	2	3	4	4–3
(I.1.+II.2.)–(X.1.+XI.1.)	Central government	–7,619	–28,197	–20,578
(I.2.+II.3.)–(X.2.+XI.2.)	Credit institutions	–26,820	–37,649	–10,829
(I.3.+II.1.+II.4.)–(X.3.+XI.3.)	Other	–13,992	–14,203	–211
	Net profit from interest	**–48,431**	**–80,049**	**–31,618**
from lines (I.4.–X.4.)	Forint securities	4,427	727	–3,700
from lines (II.5.–XI.4.)	Derivative transactions for hedging and other purposes*	–9,177	–16,553	–7,376
from lines (II.5–XI.4.)	Other	–569	1,884	2,453
(I.4.+II.5.)–(X.4.+XI.4.)	**Net interest related profit**	**–5,319**	**–13,942**	**–8,623**
(I.+II.)–(X.+XI.)	**Net interest and interest related income**	**–53,750**	**–93,991**	**–40,241**

** For details on derivative transactions for hedging and other purposes, see the last table in this section.*

In 2011, the MNB recorded a net interest and interest related loss of HUF 94 billion, up HUF 40.2 billion compared to the figure for end-2010, which was a loss of HUF 53.7 billion.

Net interest income was lower by HUF 31.6 billion in comparison with end-2010.

The net interest income was increased by the following factors:

– an increase in interest income on foreign exchange reserves of HUF 36.4 billion in 2011,

– a decrease in interest expenses on other foreign currency liabilities of HUF 3.7 billion. The amount of bonds issued previously by MNB decreased because of maturity, which caused lower interest payment related to the bonds.

The net interest income was decreased by the following factors:

– higher interest expenses on government deposits denominated in forint and in foreign currency of HUF 17.2 billion relative to 2010,

– a decrease in interest income on government bonds of HUF 3.4 billion,

– higher interest expenses on credit institutions' deposits by HUF 12.4 billion,

– an increase in interest expenses on two-week MNB bills of HUF 39.5 billion compared to the preceding year.

The net interest related income fell by HUF 8.6 billion. The interest related income on securities denominated in forint (government bonds and mortgage bonds) saw a decrease of HUF 3.7 billion. This consists of the difference between the cost value and the face value of the securities recorded at cost, attributable to the reporting period. A decline in interest related profit of HUF 7.4 billion was caused by the net gain or loss on derivative transactions which are not related to exchange rate changes.

Realised gains/losses from financial operations

HUF millions

P/L line	Description	2010	2011	Change
IV.	Realized gains from financial operations	52,310	81,273	28,963
XIV.	Realized losses from financial operations	73,978	56,573	–17,405
IV.–XIV.	**Net financial gains/losses**	**–21,668**	**24,700**	**46,368**

Realised gains and loss from financial operations include gains and losses arising from sales and maturities of securities and those related to CDS transactions.

Net realised gains from financial operations amounted to HUF 24.7 billion in 2011, up HUF 46.4 billion compared to the loss for 2010.

Details of income from derivative transactions for hedging and for purposes other than hedging represented in interest related income

HUF millions

No.	Description	2010	2011	Change
1.	– interest income on currency swaps	9,944	4,129	–5,815
2.	– income like interest margin on hedge interest rate swaps	6,876	1,121	–5,755
3.	– interest gains on hedge FX swaps	3,913	4,863	950
4.	– FX gains on derivative transactions	0	7,714	7,714
5.	– income from fees on hedge option transactions	0	108	108
6.	– interest income on other transactions	3,312	577	–2,735
7.	**Income from derivative transactions (1+2+3+4+5+6)**	**24,045**	**18,512**	**–5,533**
8.	– interest expences on currency swaps	11,521	4,468	–7,053
9.	– expense like interest margin on hedge interest rate swaps	1,522	355	–1,167
10.	– interest loss on hedge FX swaps	14,398	11,463	–2,935
11.	– FX losses and other expenses on derivative transactions	417	16,955	16,538
12.	– expences from fees on hedge option transactions	0	384	384
13.	– interest expenses on other transactions	5,364	1,440	–3,924
14.	**Expenses on derivative transactions (8+9+10+11+12+13)**	**33,222**	**35,065**	**1,843**
15.	– net interest on currency swaps (1–8)	–1,577	–339	1,238
16.	– interest margin on hedge interest rate swaps (2–9)	5,354	766	–4,588
17.	– net interest gains on hedge FX swaps (3–10)	–10,485	–6,600	3,885
18.	– interest related income on derivative transactions, net (4–11)	–417	–9,241	–8,824
19.	– interest related income on hedge option transactions, net (5–12)	0	–276	–276
20.	– net interest on other transactions (6–13)	–2,052	–863	1,189
21.	**Net income from derivative transactions (7–14)**	**–9,177**	**–16,553**	**–7,376**

Currency swap transactions include derivative transactions concluded with foreign partners and with the ÁKK. The former provide for hedging exchange rate and interest rate risks arising from bonds issued in the past by the MNB abroad. The net interest result of the currency swaps was a loss of HUF 0.3 billion, an improvement of HUF 1.2 billion compared to 2010.

The HUF 4.6 billion decrease in the interest result on interest rate swaps was caused partly by the maturity of transactions and partly by the change in foreign exchange interest rates.

Net interest gains on FX swaps increased by HUF 3.9 billion for two reasons: due to the FX swaps contracted with credit institutions related to early repayment and to the higher foreign exchange interest rates in comparison with 2010, with the latter causing a decrease in the interest margin.

Net interest related income on derivative transactions decreased by HUF 8.8 billion because of the increase of expenses on hedge bond futures transactions.

Net interest on other transactions increased by HUF 1.2 billion mainly due to the increase of net interest on other futures transactions.

4.20 COMPONENTS OF INCOME FROM THE REVALUATION OF FOREIGN EXCHANGE HOLDINGS

HUF millions

Description	2010	2011
Net income from exchange rate changes (realised and conversion spread)*	50,370	98,685
Change in revaluation reserves in the balance sheet** (due to unrealised revaluation net income)	185,145	909,026
Total effect of exchange rate changes	**235,515**	**1,007,711**

** P/L line: III-XII.*
*** Revaluation reserves due to exchange rate changes (balance sheet line XI.4.).*

In 2011, the total exchange rate change effect was a gain of HUF 1,007.7 billion, of which the Bank realised HUF 98.7 billion, while the amount of the revaluation reserve due to exchange rate changes (unrealised gain) increased by HUF 909 billion during the year.

For more details on revaluation reserves, see Section 4.17.

4.21 COST OF ISSUING BANKNOTES AND COINS

HUF millions

P/L line	Description	2010	2011	Change
	Cost of banknote production	5,901	2,711	−3,190
	Cost of coin production	1,811	1,439	−372
	Cost of production of commemorative and collector coins	835	737	−98
XIII.	**Cost of issuing banknotes and coins**	**8,547**	**4,887**	**−3,660**

The cost of issuing banknotes and coins was HUF 4.9 billion in 2011, a decrease of HUF 3.7 billion compared to the preceding year. Cost of banknote production was lower by HUF 3.2 billion, due to a decrease in the quantity of banknotes produced and lower acquisition costs.

4.22 OTHER INCOME/EXPENSES

HUF millions

P/L line	Description	2010	2011	Change
V.1.	Income from fees and commissions	821	1,076	255
XV.1.	Expenses of fees and commissions	660	743	83
	Net income from fees and commisssions	**161**	**333**	**172**
V.2.	Income from other than fees and commissions	5,541	3,091	−2,450
XV.2.	Expenses of other than fees and commissions	1,599	830	−769
	Net income from other than fees and commisssions	**3,942**	**2,261**	**−1,681**
V.–XV.	**Other net results**	**4,103**	**2,594**	**−1,509**

Income from fees and commissions, mainly related to payment services, saw an improvement of HUF 0.2 billion compared to the figure for 2010. Higher income from fees and commissions stemmed from the increase in fees on transactions settled in VIBER (real-time gross settlement system).

For more details on income other than fees and commissions, see Section 4.23.

4.23 INCOME OTHER THAN FEES AND COMMISSIONS

HUF millions

No.	Description	2010	2011	Change
1.	Dividends from investments	4,694	2,263	−2,431
2.	Income related to coins and commemorative coins	822	719	−103
3.	Income from sales or transformation of invested financial assets	1	62	61
4.	Income from assets assigned free of charge	0	2	2
5.	Other income	24	45	21
6.	**Income from other than commissions and charges (1+2+3+4+5)**	**5,541**	**3,091**	**−2,450**
7.	Final money transfer	204	225	21
8.	Expenses related to coins and commemorative coins	702	377	−325
9.	Expenses from sales or transformation of invested financial assets	0	7	7
10.	Expenses from assets assigned free of charge	681	211	−470
11.	Other expenditures	12	10	−2
12.	**Expenses from other than commissions and charges (7+8+9+10+11)**	**1,599**	**830**	**−769**
13.	**Net income/expenses from other than commissions and charges (6−12)**	**3,942**	**2,261**	**−1,681**

Income other than fees and commissions includes the following:

– Dividends from investments decreased by HUF 2.4 billion compared to 2010. An explanation for this is that on the one hand, the BIS paid a significantly high dividend in 2010, while the dividend paid in 2011 was of the usual value, and on the other hand, the dividends from Pénzjegynyomda Zrt. and Magyar Pénzverő Zrt. were lower. In 2010, Pénzjegynyomda Zrt. paid dividend above its profit, namely an additional amount of HUF 400 million from its retained earnings and Magyar Pénzverő Zrt. also expanded its dividend with the transfer of a building worth HUF 477 million.

– The item 'Expenses from assets assigned free of charge' includes the book value of HUF 208 million of the warehouse at Soroksári út, Budapest, which was transferred to the Hungarian State Holding Company (MNV Zrt.).

– The items 'Income from sales or transformation of invested financial assets' and 'Expenses from sales or transformation of invested financial assets' include net extraordinary gains arising from the increase in the book value of KELER KSZF Kft. when its form of operation changed to company limited by shares.

– The item 'Final money transfer' mainly includes donations to domestic organisations and foundations.

4.24 OPERATING INCOME AND EXPENSES

HUF millions

P/L line	Description	2010	2011	Change
	Income from assets and inventories	8	36	28
	Income from subcontracted services	32	16	−16
	Income from invoiced services	130	127	−3
	Other income	19	22	3
	Extraordinary income	1	1	0
VIII.	**Total operating income**	**190**	**202**	**12**
	Cost of materials	3,835	3,433	−402
	Personnel-related costs	7,009	6,884	−125
	Depreciation	2,180	1,800	−380
	Transfer of costs of other activities	−241	−235	6
	Total operating costs	**12,783**	**11,882**	**−901**
	Expenses incurred on assets and inventories	11	12	1
	Expenses incurred on subcontracted services	24	16	−8
	Expenses incurred on invoiced services	130	128	−2
	Other expenses	7	26	19
	Total operating expenses	**172**	**182**	**10**
XVIII.	**Total operating costs and expenses**	**12,955**	**12,064**	**−891**
VIII.–XVIII.	**Net operating expenses**	**−12,765**	**−11,862**	**903**

Net operating expenses amounted to HUF 11.9 billion in 2011, a decrease of HUF 903 million (7.1 per cent) compared to the previous year. This result is determined mainly by total operating costs, which were lower by HUF 901 million in 2011 relative to 2010, due to the following changes in its components:

The *cost of materials* in the reporting year decreased by HUF 402 million (10.5 per cent) compared to 2010, owing to the following:

– Operating costs decreased by nearly HUF 190 million relative to the previous year. This was partly the result of using one supplier instead of many suppliers by type of services in the central building. Furthermore, during 2010 the bank vacated the building at Hold u. 7, Budapest, which resulted full-year savings in 2011 in different types of costs. Savings were also generated by the decrease in operating costs of cash logistics machines, by providing the operation of an automated depository with the bank's own staff and by the new care-and-maintenance contract for banknote processing machines at advantageous rates.

– IT costs decreased by more than HUF 70 million compared to 2010. Costs were significantly influenced by the modernisation of procurement processes supporting the operation of IT devices and the decrease in the use of IT consulting costs.

– Other cost of materials decreased by HUF 140 million. The tasks and costs related to the Holocaust trial were taken over by the Ministry of National Development in 2011, which caused a decrease of more than HUF 96 million. Costs of communications were also lower by HUF 40 million relative to 2010.

The audit fee amounted to HUF 37.7 million.

Personnel-related costs decreased by HUF 125 million (by 1.8 per cent). This was a result of mainly two factors: due to the reduction in the remuneration of the Governor, the Deputy Governors and the members of the Monetary Council pursuant to the amendment of the Act on the MNB, and due to the decrease in personal income tax paid by the employer . These savings were reduced by the rise of wages carried out at the beginning of 2011.

Depreciation decreased by HUF 380 million (by 17.5 percent) in 2011 in comparison with the previous year and broadly in line with the target. This was a result of the increase of the assets written off and the application of depreciation rates adjusted to the longer useful economic life of the assets.

4.25 CHANGES IN THE NUMBER OF EMPLOYEES, WAGE COSTS AND REMUNERATION OF THE BANK'S EXECUTIVE OFFICERS

Number of staff and wage information

HUF millions

Description	2010	2011	Change (%)
Wage costs incurred on staff	4,492	4,439	−1
Other wage costs*	228	214	−6
Wages	**4,720**	**4,653**	**−1**
Other personnel payments	**846**	**800**	**−5**
Taxes on wages	**1,443**	**1,431**	**−1**
Personnel-related costs	**7,009**	**6,884**	**−2**

** Other wage costs include payments on dismissal and in exchange of vacation time used and amounts paid to non-staff and non-MNB workers.*

Description	2010	2011	Change (%)
Average number of staff	591	590	−0.2

Remuneration of executive officers

HUF millions

Bodies	Fees
Monetary Council*	36
Supervisory Board	82

** Includes the salaries and employer's voluntary pension fund contributions of external members of the Monetary Council in an employment relationship with the MNB, pursuant to Article 46 paragraph (4) c) of the new Act on the MNB.*

The senior officers, such as members of the Management Committee and the Supervisory Board, had no loans outstanding vis-à-vis the Bank in 2011.

The Bank has no obligation to pay pension benefits to its former senior officers.

4.26 DISTINCTION BETWEEN THE ESCB GUIDELINE AND MNB ACCOUNTING POLICY

In connection with the loan drawn down in 2009 by the MNB, the IMF specified that the MNB was obliged to present the quantified difference between its accounting policy and the ESCB guideline in its annual report. These distinctions originated from reclassifications, different principles of valuation and asymmetrical recognition of profit typical of the ESCB's accounting. The balance sheet and profit and loss account are prepared as if each business year would be the first one compiled according to ESCB rules, i.e. the effects of previous years are not calculated.

According to ESCB rules, the balance of the foreign currency bonds repurchased by the MNB reduced the amount of MNB bonds presented on the liabilities side of the balance sheet, while the MNB records them as receivables on the assets side.

According to ESCB valuation rules, in contrast to the MNB's accounting policy, market valuation is used for a broader field of securities and derivative transactions. As an exception, securities classified as held-to-maturity must be valued at amortised cost and are subject to impairment if necessary.

According to MNB accounting policy, unrealised gains and losses arising from market valuation and exchange rate changes shall be recognised in 'Revaluation reserves of foreign currency securities' and 'Revaluation reserves due to exchange rate changes', respectively. By contrast, under ESCB rules only unrealised gains as a kind of reserve in 'Revaluation accounts' are recognised on the liability side of the balance sheet. The character of revaluation accounts is similar to the revaluation reserves applied by the MNB, but they are not a part of equity according to ESCB rules, and provide cover solely for possible foreign exchange losses and negative market price differences of further periods. The not realised loss has to be taken into account in the result for the year, but this loss is reduced partly or as a whole by the not realised gain arising on the given instruments and positions, which has accumulated on the revaluation accounts in the previous years.

As a result of the principle of prudential valuation and profit recognition (the latter means the asymmetrical recognition of unrealised profit or loss), in the balance sheet according to the ESCB rules a negative balance of the revaluation accounts is not allowed, as opposed to the Hungarian methodology. The revaluation accounts recorded by ESCB rules show higher balances than the revaluation reserves recorded by the MNB, but the realised profit for the year is lower at the same time.

Factors adjusting balance sheet total and equity in 2011

HUF millions

Description	Assets	Liabilities
Totals according to HAS	**12,501,799**	**12,501,799**
Reclassification of repurchased bonds in order to show the net amount of the issued bonds in liability side	−39,967	−39,967
Adjustments on market valuation of foreign currency securities		
Deduction of revaluation reserves of foreign currency securities due to HAS		−5,593
Revaluation reserves of foreign currency securities according to ESCB rules		44,961
Unrealised loss on foreign currency securities		−39,368
Adjustments on market valuation of derivatives	2,222	2,222
Adjustments on exchange rate changes		
Deduction of revaluation reserves due to exchange rate changes according to HAS		−1,324,963
Revaluation reserves of exchange rate changes according to ESCB rules		1,417,362
Unrealised loss on exchange rate changes		−92,399
Reclassification of loss for the year to the asset side	128,165	128,165
Total value of adjustments according to ESCB rules	**90,420**	**90,420**
Totals according to ESCB rules	**12,592,219**	**12,592,219**

HUF millions

Description	Revaluation reserves	Share capital	Retained earnings	Loss for the year	Total equity
Reference No. of HAS	**XI.4. + XI.5.**	**XI.1.**	**XI.2. + XI.3.**	**XI.6.**	**XI.**
Balance sheet data according to HAS	**1,330,556**	**10,000**	**33,426**	**13,598**	**1,387,580**
Adjustments on market valuation of foreign currency securities					
Deduction of revaluation reserves of foreign currency securities due to HAS	−5,593				−5,593
Revaluation reserves of foreign currency securities according to ESCB rules	44,961				44,961
Unrealised loss on foreign currency securities				−39,368	−39,368
Adjustments on market valuation of derivatives	5,044			−9,996	−4,952
Adjustments on exchange rate changes					
Deduction of revaluation reserves due to exchange rate changes according to HAS	−1,324,963				−1,324,963
Revaluation reserves of exchange rate changes according to ESCB rules	1,417,362				1,417,362
Unrealised loss on exchange rate changes				−92,399	−92,399
Total value of adjustments according to ESCB rules	**136,811**	**0**	**0**	**−141,763**	**−4,952**
Balance sheet data according to ESCB rules	**1,467,367**	**10,000**	**33,426**	**−128,165**	**1,382,628**

As a result of the application of ESCB rules, the 2011 balance sheet total changed by HUF 90.4 billion and the profit for the year changed by HUF 141.8 billion.

Due to reclassification of the repurchased MNB foreign currency bonds (stated in net amount), the balance sheet total decreased by HUF 40 billion, whereas due to the market valuation of derivative transactions and the loss for the year to the asset side it increased by HUF 2.2 billion and by HUF 128.2 billion, respectively.

The result for the year changed to a loss of HUF 128.2 billion as a consequence of recording the unrealised loss due to the foreign exchange rate changes and market valuation. Revaluation reserves amounted to HUF 1,467.4 billion according to ESCB rules, due to settlement of unrealised profit.

23 April 2012, Budapest

András Simor
Governor of the Magyar Nemzeti Bank

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