



MINISTRY
FOR NATIONAL ECONOMY

21st Century Hungary as Regional Financial Centre

Focus

The new Hungarian government is firmly determined to make Hungary the 21st century financial services centre of Central Europe by the recently released, long-term and sound economic policy concept. To reach European competitiveness standards, we intend to create an environment with such taxation as well as legal and market regulatory background which, by stimulating financial investments, could turn Hungary into an attractive destination for foreign institutional investors and which could facilitate the long-term rise of domestic savings rate.

Background

- The credibility of economic policy has been severely compromised during the past eight years in Hungary.
- The country has suffered a setback among the peers in the region.
- Financial services providers have become uncompetitive and expensive.
- The goal of the government is to regain the trust of foreign investors in Hungary and to make the country's economy a determining factor in the region and competitive EU-wide.
- The tax system must be reformed (corporate tax must be cut radically, tax on dividends and capital gains must be reduced and tax breaks up to 100% must be introduced).
- The Hungarian Financial Supervisory Authority (HFSA) must be made more efficient with broader competences.
- The government is committed to improve the quality of financial services.
- A higher domestic savings rate must be achieved.
- The savings structure must be reformed.

“Cornerstones”

I. A reform of investment funds' regulation

Hungary is well prepared and ready to implement on time the EU regulation amendments about public open-ended investment funds ratified by the European Committee and the European

Parliament which will enter into force in the first half of 2011. The EU regulates open-ended investment funds by the directive titled Undertakings for Collective Investment in Transferable Securities. The essence of this directive is that an investment fund established or their collective investment security issued in any EU member state can be marketed in other EU member states after having notified the competent authorities. The primary goal of the directive is to facilitate the creation of a global and concentrated fund management market by helping cross-border sales and operation through standard regulation. Hungary is committed to meet the expectations of an efficient market and we support EU efforts to create a global investment market as well.

The key elements of the UCITS IV directive:

- Management company passport: without an extra licensing procedure, any UCITS fund manager can establish and operate a UCITS fund in another EU member state without setting up a local company. By having defined this rule, the amendment overrides any potential legal obstacle of national regulations.
- The cross-border merger of funds: the new amendment staves off potential obstacles by national regulation.
- Introduction of master-feeder structures: in case of UCITS funds, it is also possible to establish such a fund of funds which is allowed to invest the majority of its resources even into a single fund in another EU member state.
- KID (Master Information Document): a short guide of uniform content aimed at replacing the haphazardly adopted, previous shortened versions and thus reducing considerably the administrative burden of cross-border sales.

The introduction of new regulated is complemented by the previously announced tax reform. From 1 January 2011, capital gains from the sale of equities are subject to a flat-rate tax of 16%. In case of investments in Long-term Investment Accounts (LIA) and Pensions Savings Accounts (PSA), there is 100% tax break for the tax on dividends and capital gains. These factors can make Hungary an attractive destination on the global fund management market. On the one hand, they can retain market players considering relocation; on the other hand the new regulatory environment may lure such prestigious foreign fund managers with substantial managed wealth who could meaningfully increase the size and quality of domestic market. Their know-how could considerably improve the quality of financial services and lay the foundations of stabile and lasting investor confidence. We are also expecting a structural change in the savings of the population (deposit vs. investment certificates or ETFs), which can stimulate the investment fund market and generate greater competition among the funds. The introduction of new marketing channels will compel

financial services providers in the intensifying competition to improve the quality and reliability of their offerings which will be regarded as the most precious added value for investors having been disappointed with the system because of the 2008 crisis.

II. AIFMs (Directive on Alternative Investment Fund Managers)

The wording of the new directive was preceded by the realization that the financial crisis has turned attention to such fund types and fund managers which had been outside the scope of regulation before and could therefore play a part in the escalation of the crisis. (Mostly hedge funds have been targeted so far by politics.) The primary rationale of the directive is that only such funds should be on sale in the EU whose management fully complies with the rules set by the directive. In return, however, fund managers complying with the rules of the directive are allowed to sell their funds without any further restrictions to institutional customers within the EU. The specification of sales conditions for private customers would remain under the jurisdiction of individual member states, but, naturally, the fund manager would still have to abide by the directive too. There will be an imminent impact of the directive on those domestic funds and fund managers which have so far been under the authority of national regulation as they will get into the scope of the directive. With the exception of a couple of funds, currently the entire domestic fund market belongs to this category. This new regulation will change the routine of providers that they only offer investment funds under their management and instead of creating copycat funds they will more actively take part in the competition of product development. Parallel to a broader variety of products with presumably several thousand funds on offer, there will be services of higher quality with improvement in professionalism and in the premium and private banking segments together with lower costs. The improvement of sales efficiency can increase the trust of market participants in the entire financial services provider system. This new situation will be a challenge and a great opportunity as well for domestic fund managers.

III. Real Estate Investment Trust (REIT)

Upon the basis of the declared objectives of economic policy, to make Hungary one of the most competitive EU member states and the financial services centre of Central and Eastern Europe or the *Luxemburg of Eastern Europe*, the government have been working out new legislation. The establishment of legislation for public real estate investment funds (REITs) with domestic ownership serves several economic policy goals of strategic importance. The government intends to create such optimal and business-friendly regulatory environment which can generate fresh capital

flow to the Hungarian real estate market from, primarily, domestic and foreign institutional investors which can materialize in substantial real economic advantages for the entire sector because of the expected boost to property development activity. It would also address a wide range of investors, like specialized investors or big equity and bond investors.

A REIT will be a **stock exchange-listed public company** funded by small private and big institutional investors which will hold primarily Hungarian commercial and residential real estate assets for management or development purposes. The majority of the profit (90%) from real estate asset management would be returned to shareholders as dividends. It is a principle of this financial product that **income from REIT would only be subject to dividend or capital gains tax for shareholders.**

By the establishment and stock market listing of REITs the government intends to support property developers and real estate investment companies with Hungarian ownership. Besides that, the stimulation of the domestic rented property market has been a priority of economic policy in order to increase Hungarian workforce mobility. This requires additional private capital which may be funneled into the system primarily by REITs.

There are four potential opportunities by the establishment of Hungarian REITs:

1. REITs secure a stable market for domestic property developers. A long-term strategic partnership can be established between property developers, REITs and banks, and the calculable environment will stimulate new developments and investments.
2. REITs provide a competitive holding structure which can replace international off-shore structures (i.e. in Luxemburg or Cyprus). The replacement of foreign holding structures can result in the return of wealth worth tens of billions of HUF. The dividend tax and preferential tax on the sale of real estate from REIT investments will generate new, direct revenues for the budget.
3. In the medium term, the establishment of REITs will result in the creation of about 10 000 new jobs because of the indirect effects of the construction sector's expansion. There will be new jobs for highly qualified professionals in the fields of financial services, accounting and real estate management in the following sectors:
 - Account management – credit institutions
 - Sales, stock brokerage – brokerages, Budapest Stock Exchange, Central Clearing House and Holding Agency (KELER)
 - Property valuation, transaction consulting – property consultation companies

- IFRS – consolidation, audit, net asset value calculation – accountancies
- 4. REITs can reach a broader investor base than domestic real estate funds (big foreign institutional investors, pension funds, etc.)

Main elements of the concept:

1. Modification of regulation on share accounting and shareholders' institutional representation in order to meet investors' expectations.
2. The establishment of competent judicial bodies on tax affairs in order to increase legal security of the investments.
3. The creation of an efficient system for resolutions on tax law.
4. The creation of a competitive tax system capable of attracting syndicated loan providers and financial holding companies.
5. The full utilization of the opportunities offered by the convention on the avoidance of double taxation.

Conclusion

The implementation of the concept offers a great opportunity for Hungary, as emerging market economies have been looking for investment destinations for their capital deposits (the sovereign funds of China, India, the Middle East) during the recovery from the global financial crisis. Due to the Hungary's geological position optimal for the financial services sector, it has become possible for the country to be the "*Luxemburg of Eastern Europe*".

Budapest, 30 November 2010.

Ministry for National Economy