



**HUNGARIAN BANKING ASSOCIATION**

# *REPORT*

**ON 2011 ACTIVITIES OF THE HUNGARIAN BANKING  
ASSOCIATION**

*BUDAPEST, MARCH 2012*

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## **Executive Summary**

The Hungarian Banking Association saw one of the busiest periods ever in its history in 2011, mainly due to the difficult economic situation and the issue of debtors with foreign currency denominated loans. Also, in the context of Hungary holding the EU presidency for the first time in the first half of 2011, the Hungarian Banking Association hosted the European Banking Federation's Board and Executive Committee as well as other committee meetings in Budapest.

A key endeavour of the government in 2011 was to ease the repayment burdens on households with foreign currency denominated mortgage loans and to mitigate the day-to-day financial consequences of their overindebtedness. To achieve this, the government adopted various solutions, sometimes by cooperating with and sometimes by severely infringing the interests of the banking sector.

While trying to help debtors in every possible way, including the easement of payments and the rescheduling of debts, the banking community continued to be open to negotiations with the government to seek a comprehensive solution to the issue. We conducted continuous consultations and made coordinated specific commitments to help debtors, continuously assessing the situation and the possible solutions.

The government announced a 5-point Home Protection Action Plan on May 31, 2011. After negotiations with the Association in the first half of 2011, the government started implementing the Action Plan. Elements of the Action Plan included the introduction of an exchange rate cap, the development of an interest subsidy scheme, the setting up of a National Asset Management Company, the lifting of the eviction moratorium and the introduction of auctioning quotas, and the lifting of the ban on foreign currency-denominated mortgage lending.

While members carried out the necessary preparations for managing the exchange rate cap taking effect on August 12, 2011 and the related overflow account scheme, the Association reviewed, commented on and submitted proposals to the Ministry for National Economy on a number of implementation-related issues and also carried out consultations with the Hungarian Chamber of Notaries.

However, in mid-September, the government, in a record short period and without any preliminary consultation, had the Act on Early Repayment passed by Parliament. The Act had to be amended in several points since then. The Association expressed on all possible forums its concerns about the unconstitutionality of the Act, its potential economic impacts and the difficulties in implementing it. Based on the Board's decision, the Association and the affected banks filed a case with the Constitutional Court. Regulatory changes in 2012 made it necessary for the banks directly affected by the early repayment scheme to refile the case with the Constitutional Court in the form of a constitutional complaint. The Association drafted and coordinated the filing of the complaint. In addition, some parent banks filed a case with the European Court of Justice.

As a key point of the May agreement with the government, the National Asset Management Agency (NAMC) was set up in the autumn. The Association was involved in the drafting of the relevant legislation. The value limits set in the May agreement were incorporated in the proposed legislation on the NAMC. However, the detailed rules for the NAMC were significantly changed compared to the original plans. Based on the Association's comments, the government agreed to

review the legislation and (also at the Association's initiative) to extend the scope of those eligible to include all families with at least one child.

At the initiative of the Government, a new series of negotiations were launched in October. As a result of these negotiations, a compromise agreement also acceptable for banks was reached on December 15. In addition to ending the early repayment scheme (objected to by banks and still subject to legal action), the agreement provided adequate guarantees that no new special burdens would be imposed on the sector. The agreement also allows banks to offset against the special bank tax a part of their losses arising from the debtor rescue packages.

Another forward-looking element of the agreement is that the burdens arising from the exchange rate cap scheme, made available for a significantly widened range of performing debtors, will be shared between the banking sector and the government. The growth pact stipulated in the agreement, currently under drafting, also signals increased cooperation between the parties.

The Association considers it a major success that, after years of debate, in the context of the government's Home Protection Action Plan, the Parliament enacted a law on setting up a positive debtors' list. However, the legislation, adopted under urgency, in its original form made implementation difficult in a number of points. We submitted proposals for the necessary amendments and the legislation was amended accordingly.

The Association launched a project for setting up a Central Credit Bureau by the extremely tight deadline set. We conducted consultations, made proposals for customer information and provided banks with information and assistance in creating the necessary legal conditions for data transmission.

In addition to addressing the issue of retail debtors, we set up high level working groups and expert groups to address current issues related to municipality and SME lending. The ensuing proposals were reviewed at meetings with representatives of the competent organisations and also forwarded to the competent government departments.

An important development in 2011 was the launch of the Financial Arbitration Board. Already during the review of the relevant draft law and implementation decrees, we expressed our concerns about the proposed organisational structure. Our main concern was the incorporation of the Financial Arbitration Board into the Hungarian Financial Supervisory Authority (PSZÁF). Nevertheless, the Association's Board, by taking into account the request of PSZÁF's president, recommended that members issue a statement of submission to decisions of the Financial Arbitration Board for cases below a certain contract and claim value. Banks were free to decide on whether or not to submit to the Financial Arbitration Board's decisions.

The Association actively participates in all committees of the Intergiro2 (IG2) project, aimed at introducing intra-day settlements in Hungary. As a result of effective work and cooperation, the project is expected to be implemented according to schedule.

The Association's Legal Working Group reviewed and commented on an unprecedented volume of laws drafted and adopted in 2011, including the Bankruptcy Act, the Act on Bankruptcy and Liquidation Rules for Companies of National Importance, the Act on Judicial Distraint, the new Data Protection Act, the new Labour Code, and the new Civil Code.

The Association's associates also represent the banking community on the Boards of the National Deposit Insurance Fund (OBA) and the Investor Protection Fund (BEVA). In 2011 we succeeded in protecting banks' interests regarding OBA's customer information proposal and preventing an increase in the OBA fees. A major development regarding BEVA in 2011 was the introduction of risk-related fees.

The Association's associates were actively involved in operations of the European Banking Federation's working committees. We are also represented by delegates from member banks in the EBF's newly set up working groups on financial sector taxes and risk assessment. The EBF's Executive Committee addressed Hungary-related issues, including the early repayment scheme, and supported our requests.

Global and European financial regulatory work in 2011 was characterised by the development of detailed proposals to address the challenges arisen in the wake of the economic crisis: the work of previous years was continued. Regulatory endeavours continued to be focused on strengthening banks' capital and liquidity standards, tackling bank crises and systemically important financial institutions, the regulations on central counterparties and on OTC derivatives and the enhancement of supervisory practices. In response to the anti-bank sentiment, the EBF is giving special emphasis to its communications strategy. A new communications strategy for the EBF is being developed under the leadership of our János Müller, Chair of the EBF Communications Committee.

## I. Economic environment – Performance of the Hungarian banking sector in 2011

In a modestly growing economy, **assets in the banking sector continued to stagnate** in nominal terms and decline in real terms in 2011. The **NPL** rate for household and corporate loans **grew** by 3 and 5 percentage points, respectively (such a magnitude of growth in NPL is unlikely to recur in 2012, if the **agreement with the IMF** materialises). The burdens on debtors with foreign currency-denominated loans increased due to the weak forint. Banks' profitability was virtually entirely determined by the government, directly (through the special bank tax and the burdens entailed by the early repayment scheme) and indirectly (through Hungary's CDS spread), pushing banks into the red (**ROE: -3,8 %**, real ROE: -7,5 %). The sector's capital adequacy ratio was satisfactory (13,47%).

The global economy grew by 3.8%. The economy grew by 1.6% in the EU, 5.1% in the CEE countries and **1.7% in Hungary**. The assets of Hungarian financial institutions (banks + branches of foreign banks + co-operatives) rose by 2.7% over 2010 (securities, making up 22.6 % of all assets, increased by 5.2%, central and interbank deposits, representing 7.8% of all assets, rose by 14.1%, loans, taking up 59% of all assets, declined by 2%). The ratio of customer loans to GDP (the depth of financial intermediation) was 51%, basically the same as in 2007, which corresponds to the level of development of the country.

**Table 1 - Banks' asset structure at current prices (in HUF Billion)**

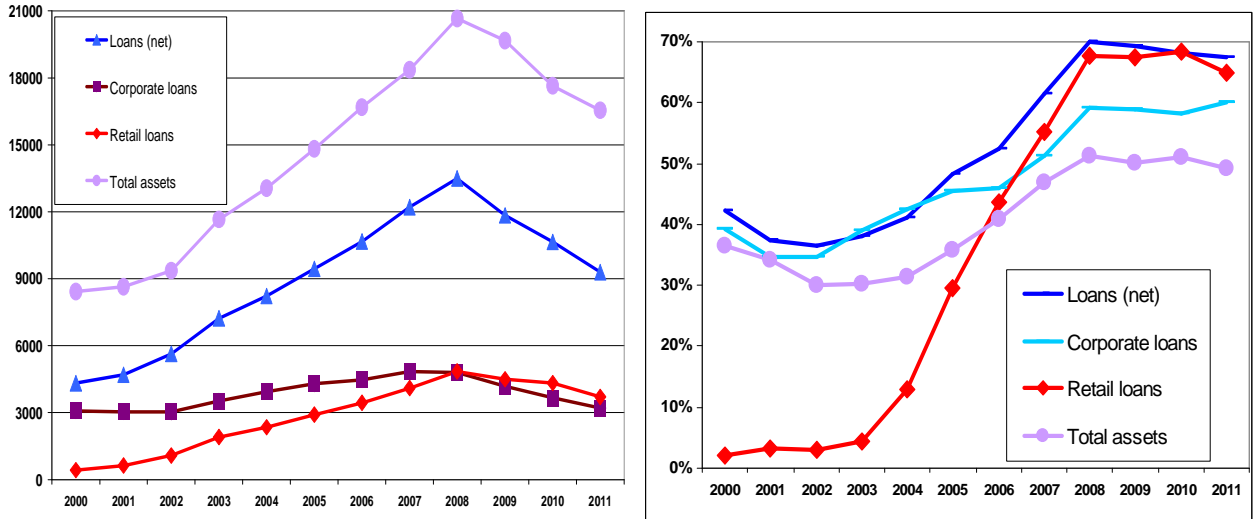
	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Cash and settlement accounts	689	644	491	452	726	697	689	812	606	535	572	612
Securities for trading	580	487	458	674	645	629	930	1649	1904	3529	2494	2623
Securities for investment	740	1004	1059	1481	1455	1560	1555	1741	2770	3046	3560	3825
Total securities	1320	1491	1517	2155	2100	2189	2485	3390	4674	6575	6054	6448
Central bank and interbank deposits	1528	1476	1445	1287	1614	2179	2379	1634	1435	1649	1532	1908
Of which: central bank deposits	-	492	643	424	541	1291	1205	446	500	310	305	726
deposits	-	984	802	863	1073	889	1174	1188	936	1340	1227	1181
Loans (net portfolio)	4323	4905	6097	8125	9483	11371	13462	16439	19875	18194	18055	17582
of which: corporate loans	3076	3176	3284	4031	4613	5236	5716	6566	6947	6334	6004	5801
Retail loans	429	677	1204	2000	2597	3371	4243	5450	7130	6719	7194	6834
Participations	192	156	197	254	240	285	488	542	629	640	675	766
Accrued interest receivable	117	109	114	171	231	224	214	268	461	423	307	334
Prepayments and other assets	71	90	144	180	232	256	506	655	915	457	400	664
Own assets	187	169	192	237	287	359	540	635	583	523	530	593
<b>Total assets</b>	<b>8427</b>	<b>9040</b>	<b>10196</b>	<b>12861</b>	<b>14912</b>	<b>17559</b>	<b>20763</b>	<b>24376</b>	<b>29178</b>	<b>28996</b>	<b>28125</b>	<b>28906</b>

Source: PSZAF

To estimate the value of assets in real terms, we used several filters, by first adjusting foreign currency loans with a basket of 50% EUR, 50% CHF, and then dividing the total portfolio by the consumer price level. Total assets in the banking sector net of exchange rate effects and inflation in 2011 were at 80%, net loans at 69% of their 2008 levels (including retail loans at 67%, corporate loans at 76%); the decline compared to 2010 was 1/3 of this, with total assets being at 94%, net loans at 87% (retail loans at 88% and corporate loans at 86%) of their 2010 levels.

The right hand chart of Figure 1 below shows the share of foreign currency assets in banks' total assets in the past ten years, falling from 36% in 2000 to 29% in 2002, then rising to 51% in 2008 and dropping to 49% in 2011. The share of foreign currency loans in total corporate loans followed the same pattern (39%, 35%, 59% and 60% in 2000, 2002, 2008 and 2011, respectively). The share of foreign currency loans in retail loans hiked from 2% in 2000 to 68% in 2010, falling to 65% by the end of 2011 (partly due to the early repayment scheme).

Figure 1 - Credit institutions' assets net of exchange rate effects and inflation; the ratio of foreign currency assets



Sources: expert's estimates based on PSZAF and MNB figures

Based on current-price figures, we looked at how the market shares of the various types of credit institutions in certain assets changed between 2005 and 2011. While in 2005, banks held 93% of total assets in the credit institutions sector, their share fell to 91% in 2008 and 87% in 2011. The share of cooperatives in total assets fell from 7% in 2005 to 5% each in 2008 and 2011. Banks' share in total loans fell from 95% in 2005 to 90% in 2011. The share of cooperatives in total loans declined from 5% in 2005 to 3% in 2008 and 4% in 2011. In the period between 2005 and 2011, banks and cooperatives lost 3 and 4 percentage points, respectively, in their share in retail loans. Banks' share in corporate loans fell from 96% in 2005 to 88% in 2011, that of cooperatives rose from 3% to 5%. (A 20% increase in cooperatives' corporate loans would mean a 1% increase in total corporate loans at the sector level).

Table 2 - Changes in the share of the various types of credit institutions in certain assets

	2005	2005	2005	2005	2008	2008	2008	2008	2011	2011	2011	2011
	Banks	Branch	Coop	Total Credit Inst	Banks	Branch	Coop	Credit Inst	Banks	Branch	Coop	Total Credit Inst
Total securities	86%	0%	14%	100%	85%	7%	8%	100%	86%	7%	7%	100%
Loans (net)	95%	0%	5%	100%	95%	2%	3%	100%	90%	6%	4%	100%
Corporate loans	96%	0%	3%	100%	93%	3%	4%	100%	88%	7%	5%	100%
Retail loans	91%	0%	9%	100%	95%	0%	5%	100%	88%	7%	5%	100%
Total assets	93%	0%	7%	100%	91%	4%	5%	100%	87%	7%	5%	100%



The banking sector's **gross loans to non-financial businesses** at current prices were at HUF 6,530 billion in 2011, a 0.2% increase over 2010. The ratio of 90 day past due loans increased extremely sharply: the NPL rate rose from 10.8% in 2010 to 15.4% in 2011. The distribution of gross loans by business size did not change in the past two years.

**Table 3 - Gross loans to non-financial businesses**

	<b>Total gross loans (HUF billion)</b>	<b>NPL</b>	<b>Total</b>	<b>Large companies</b>	<b>Medium- sized enterprises</b>	<b>Small enterprises</b>	<b>Micro enterprises</b>
December 2010, audited	6,514	10.8%	100%	54%	14%	16%	16%
March 2011	6,162	11.2%	100%	53%	14%	16%	17%
June 2011	6,133	13.0%	100%	54%	14%	16%	17%
September 2011	6,423	13.8%	100%	54%	14%	16%	17%
December 2011, preliminary	6,530	15.4%	100%	53%	14%	16%	17%

Source: PSZAF

We have quite detailed figures on **gross loans to households** and the relevant NPL rates for the period between 2009 and 2011. In 2010, the NPL ratio of retail loans was 10.1%, 0.7% lower than that of loans to non-financial businesses. At the end of 2011, the NPL ratio of retail loans was 13%, 2.4% lower than that of loans to non-financial businesses. The first three columns of Table 4 below shows the figures for home loans (loans in HUF at market rates, subsidised loans in HUF and loans in foreign currency): the NPL ratio of HUF loans granted at market interest rates exceeded that of FX home loans in each year. The subsequent two columns show home equity loans in HUF and FX. Here, the NPL ratio of HUF loans is higher than that of FX loans, and the NPL ratios of both HUF and FX home equity loans are significantly higher than those of home loans. In the case of personal loans, the NPL ratio of HUF personal loans is also nearly double that of FX personal loans. In the case of car loans, the NPL ratio of HUF loans is nearly ten times higher. The last four columns show the stocks of overdrafts, consumer loans, other loans and total retail loans (without a breakdown into HUF or FX).

**Table 4 - Gross loans to households (HUF billion)**

	HUF home loans at market interest rates	Subsidised HUF home loans	FX home loans	HUF home equity loans	FX Home equity loans	HUF personal loans	FX personal loans	HUF car loans	FX car loans	Overdrafts	Consumer loans	Other loans	<b>Total</b>
2009	126	1248	2461	29	2048	261	220	23	264	399	84	245	<b>7407</b>
2010	249	1146	2819	148	2320	268	182	36	255	446	68	205	<b>8140</b>
2011	447	1028	2637	270	2290	284	138	55	274	386	46	188	<b>8041</b>
	<b>NPL</b>	<b>NPL</b>	<b>NPL</b>	<b>NPL</b>	<b>NPL</b>	<b>NPL</b>	<b>NPL</b>	<b>NPL</b>	<b>NPL</b>	<b>NPL</b>	<b>NPL</b>	<b>NPL</b>	<b>NPL</b>
2009	15.9%	1.7%	4.2%	35.1%	7.5%	11.9%	9.8%	64.8%	2.3%	19.4%	9.4%	20.5%	<b>7.0%</b>
2010	11.9%	2.4%	6.6%	16.6%	12.7%	15.6%	12.2%	60.9%	2.7%	25.6%	11.8%	23.0%	<b>10.1%</b>
2011	13.7%	2.5%	10.1%	21.4%	18.0%	21.3%	12.8%	61.5%	6.8%	12.0%	15.8%	21.4%	<b>13.0%</b>

Source: MNB

In liabilities, the minimum capital requirement was HUF 1,409 billion, regulatory capital for risks HUF 2,372, the capital adequacy ratio 13.47%. In other words, the banking sector was adequately capitalised. Only 10.3% of total subscribed capital was in foreign ownership, the lowest ratio in 9 years. 37.5% of total liabilities were denominated in foreign currency, 26.4% from abroad (45.8% of the latter in deposits).

**Table 5 - Banks' liabilities (in HUF billion)**

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Total liabilities	9040	10196	12861	14912	17559	20763	24376	29178	28996	28125	28906
FX share in total liabilities	33.6%	26.8%	27.9%	27.5%	31.6%	36.0%	38.8%	42.1%	43.1%	40.6%	37.5%
Equity/Liabilities	8.5%	8.7%	8.3%	8.5%	8.2%	8.3%	8.2%	7.5%	8.3%	8.3%	8.7%
Direct foreign liabilities/Total liabilities	16.0%	13.6%	17.7%	17.4%	21.3%	22.0%	24.6%	29.8%	28.2%	28.5%	26.4%
Foreign interbank deposits/Direct foreign liabilities	16.5%	17.7%	31.7%	27.8%	35.6%	36.6%	43.0%	42.8%	42.6%	46.0%	45.8%

Source: PSZAF

**Table 6 - Ratio of loans to domestic deposits**

2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
93%	102%	122%	130%	140%	146%	165%	181%	169%	174%	165%

Source: PSZAF

The loans-to-deposits ratio of 165% as of the end of 2011 reflected a total of HUF 19,123 billion in loans and HUF 11,593 billion in deposits. If this ratio were to be reduced "promptly" to 110%, half through loan reduction and half through deposit increase, the solution would be to encourage the swap of households' non-equity and equity securities (representing several thousand billions of forints) for deposits on the one part, while a HUF 3 billion reduction in loans could partly come from a strengthening forint and partly from the logic of a recession environment.

As for the structure of ROE in 2011:

- Net interest income was 3.0 %, the same as in the previous year. It fell from the 4% of 2002 roughly evenly to this level, which is still high compared to other countries with a greater depth of financial intermediation.
- Non-interest income was 1.0 %, 0.4 percentage points higher than in the 2010, the second lowest in 10 years. Earnings from commissions and fees fell by 0.1% over 2010, dividends grew by 0.1%. Net profit on financial and investment services and other non-interest income (inclusive of the special bank tax) each rose by 0.2 percentage points.
- Operating expenses were at 2.0 %, 0.1 percentage point lower than in the previous year. Operating expenses, 3.6% in 2002, nearly halved over 10 years.
- The change in impairments and provisions was -1.9 %, 0.6% higher than in 2010, a main factor reducing banks' ROE in 2011.
- Profit from extraordinary business activities was -0.3 %, 0.2 % worse than in 2010.
- ROA was -0.3 %, 0,3 percentage points lower than in 2010. The 2011 ROA resulted from a) an unchanged net interest income, b) a 0.5 percentage point improvement in non-interest

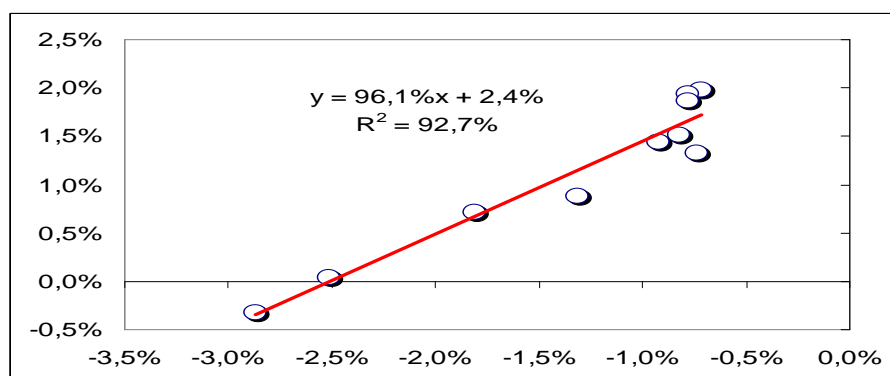
income and operating expenses c) a 0.8% deterioration in impairments and provisions + profit from extraordinary business activities.

**Table 7 - ROA and ROE in the banking sector, 2002-2012**

	2002 audited	2003 audited	2004 audited	2005 audited	2006 audited	2007 audited	2008 audited	2009 audited	2010 audited	2011 preliminary
Net interest income	4.0%	3.9%	4.0%	3.8%	3.6%	3.2%	2.7%	2.6%	3.0%	3.0%
Interest received	8.8%	9.1%	10.4%	8.5%	7.9%	8.2%	8.2%	8.5%	7.2%	7.2%
Interest paid	4.8%	5.2%	6.4%	4.7%	4.3%	5.0%	5.5%	5.9%	4.1%	4.2%
Non-interest income (net)	1.4%	1.6%	1.7%	1.6%	1.6%	1.6%	1.3%	1.9%	0.6%	1.0%
Earnings from commissions and fees	1.3%	1.5%	1.3%	1.3%	1.2%	1.1%	0.9%	0.9%	0.9%	0.8%
Dividends	0.1%	0.2%	0.1%	0.1%	0.1%	0.2%	0.6%	0.2%	0.2%	0.3%
Net profit on financial and investment services	0.4%	0.4%	0.6%	0.8%	0.6%	0.8%	0.5%	1.0%	0.7%	0.9%
Other non-interest earnings	-0.5%	-0.5%	-0.3%	-0.6%	-0.4%	-0.5%	-0.8%	-0.3%	-1.2%	-1.0%
Operating expenses	3.6%	3.4%	3.0%	2.9%	2.7%	2.6%	2.4%	2.0%	2.1%	2.0%
Change in impairments and provisions	-0.3%	-0.3%	-0.4%	-0.2%	-0.4%	-0.5%	-0.5%	-1.5%	-1.3%	-1.9%
Profit from ordinary business activities	1.6%	1.8%	2.3%	2.3%	2.1%	1.7%	1.0%	0.9%	0.2%	0.1%
Extraordinary profit	0.0%	0.0%	0.0%	0.0%	0.2%	0.0%	0.1%	-0.1%	-0.1%	-0.3%
Pre-tax profit	1.6%	1.8%	2.3%	2.3%	2.2%	1.7%	1.1%	0.8%	0.1%	-0.2%
Tax liabilities	0.3%	0.3%	0.3%	0.4%	0.4%	0.3%	0.2%	0.1%	0.1%	0.2%
After-tax profit ROA	1.3%	1.5%	2.0%	1.9%	1.9%	1.4%	0.9%	0.7%	0.0%	-0.3%
After-tax profit ROE	15.5%	17.8%	23.6%	23.3%	22.7%	17.5%	11.3%	9.1%	0.5%	-3.8%
<b>REAL ROE</b>	<b>9.7%</b>	<b>12.6%</b>	<b>15.8%</b>	<b>19.1%</b>	<b>18.0%</b>	<b>8.8%</b>	<b>4.9%</b>	<b>4.7%</b>	<b>-4.2%</b>	<b>-7.5%</b>

Source: PSZAF

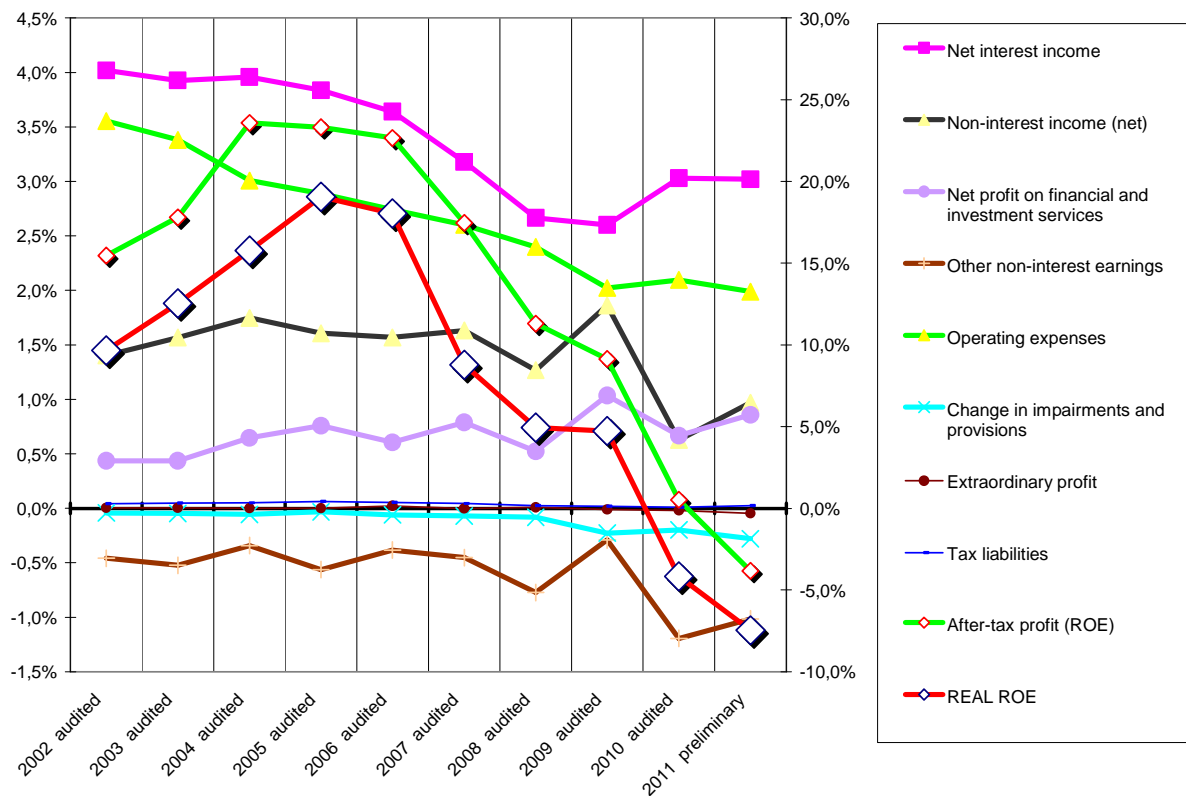
**Figure 2 - ROA as a function of non-interest income and the change in impairments and provisions between 2002 and 2011**



ROE in the banking sector was 3.8% ( HUF 92.6 billion) in 2011, **real ROE (ROE adjusted by inflation) was -7.5%**. (Cooperatives' profit after tax was +HUF 4,9 billion, that of branches of foreign banks + HUF 3,2 billion). Banks' ROA can be estimated as **ROA = 2,4% - (other non-interest income [ONII] + change in impairments and provisions [CHI])** (Figure 2). **In other words:** since the sum of (net interest income + earnings from commissions and fees + dividends +

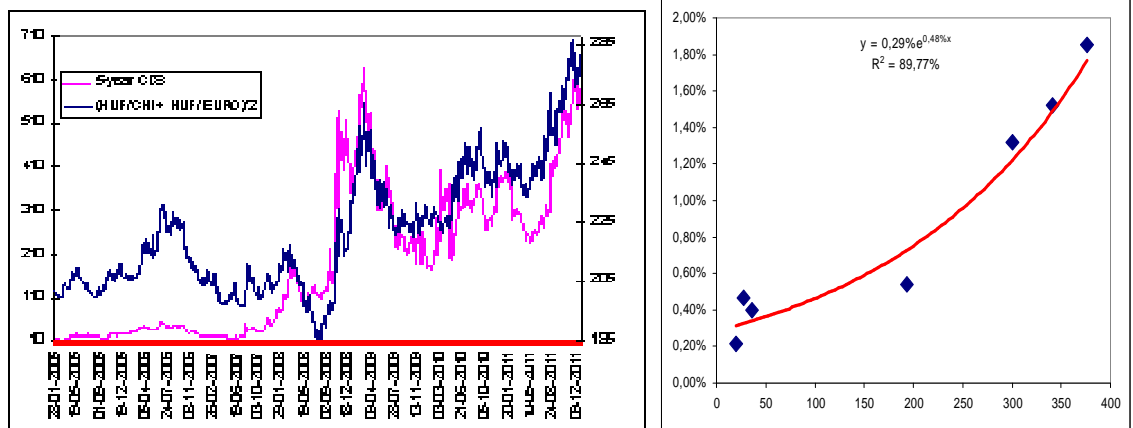
profit from financial and investment services - operating expenses - tax liabilities was constant (2.4%) between 2002 and 2011, banks' ROA was predominantly shaped by two factors: a) market-based changes in impairments and provisions and b) the special bank tax and the extra burdens imposed by the early repayment scheme. The burdens imposed by the special bank tax and the early repayment scheme (HUF 120 billion and 234 billion, respectively) made up 43% of the [ONII+CHI] total of HUF -817.5 billion.

**Figure 3 - ROA and ROE in the banking sector 2002-2011**



Banks' results were increasingly influenced by administrative burdens rather than by market factors, while in their own operations banks produced a constant level of ROE, while implementing significant cost reductions. The changes in impairments and provisions reflect the effect of several factors. An important factor was that the increase in Hungary's CDS spread caused a weakening in the HUF/CHF és HUF/EURO exchange rates, leading to the deterioration in the situation of debtors with foreign currency loans. The left-hand chart of Figure 4 reveals that the CDS spread significantly determined the **strength of the HUF** exchange rate against the HUF/EUR+HUF/CHF basket, while the right-hand chart shows that the change in **impairments and provisions** was exponentially influenced by the annual average CDS.

**Figure 4 - Impact of the CDS spread on the HUF/CHF + HUF/EUR basket and on the change in impairments and provisions, 2005-2011**



## **II. Regulation, professional issues**

### **1. Helping debtors within foreign currency loans**

#### *1.1 Overflow account loan*

Since the beginning of the year, there had been active negotiations between the Association and the government to help foreign currency debtors in distress. As a result of these negotiations, the Act on exchange rate cap scheme was adopted in July. (Act LXXV of 2011 on the fixing repayment rates the fixing of repayment rates for foreign currency loans and on foreclosures). Eligible to the scheme are loans taken by natural persons in CHF, EUR or JPY and repayable in HUF for real estates whose market value at origination did not exceed UF 30 million. For the period of exchange rate protection, the Act makes the repayment amounts for these customers predictable. During the period of exchange rate protection, until June 30, 2015, the repayment amounts will be calculated at the maximum exchange rates of 1 CHF = HUF 180, EUR 1 = HUF 250 and JPY 1 = HUF 2. For the difference between the fixed rate and the market rate, the original creditor banks provide a special mortgage loan in HUF, called overflow account loan.

The first version of the exchange rate cap scheme failed, with barely more than 3,000 debtors availing themselves of the scheme, presumably because the government's communications had suggested the possibility of introducing some even more advantageous solution. Under the agreement concluded with the government in December, the terms and conditions for the overflow account loan were favourably changed, the interest on the overflow account loans will be shared between the banks and the government. New entrants to the exchange rate cap scheme may benefit from the exchange rate cap for a period of five years, not to go beyond June 30, 2017.

#### *1.2 Early repayment scheme*

The Fidesz-KDNP parliamentary group at its September meeting proposed that the government should allow debtors to repay their foreign currency denominated loans in full at a discounted exchange rate. The Home Protection Action Plan announced on September 12, 2011 required creditors to allow the early repayment of foreign currency loans at the exchange rates of CHF 1 = HUF 180, EUR 1 = HUF 250 and JPY 1 = HUF 2. Creditors were not allowed to charge any extra fees in connection with the early repayment.

The Association learned about the plan from the media. The Board held extraordinary meetings to address the issue. In a press release, the Board drew attention that the proposed measure would jeopardise the stability of the financial system and might draw serious economic consequences. The European Banking Federation also expressed its objection to the proposed legislation.

Act CXXI of 2011 amending certain Acts related to home protection, submitted as an individual MP motion, was passed by Parliament under urgency, without any preliminary consultations, on September 19. The Association turned to the President of the Republic, asking him to refer the Act to the Constitutional Court for review. The President rejected the request in an open letter and signed the Act on September 26. The Act was promulgated on the same day and took effect on September 29.

The Association and banks involved in foreign currency lending and representing the vast majority of the market turned to the Constitutional Court, but the Court failed to decide the case. Following the enactment of the new Fundamental Law, the banks involved refiled the case in the form of a constitutional complaint.

The Act had to be amended twice right after its adoption. However, a number of unclear legal and other issues still remained at the end of the year. Around 170,000 debtors availed themselves of the early repayment scheme, repaying 24% of the portfolio, to a value of HUF 1.355 billion. The early repayment scheme caused banks a loss of HUF 370 billion. Banks can deduct 30% of this loss from their 2011 special bank tax, thus the net loss may be around HUF 260 billion.

### ***1.3 Agreements under the Minutes of Understanding concluded between the Association and the government in December***

The Early Repayment Act, which can be regarded as nationalisation without compensation, and the related government communications caused banks exorbitant losses, many had to increase their capital to sustain them. In addition, lending virtually stopped, and the confidence that is essential for any long-term planning and financing decision-making was damaged. This situation was unsustainable. Hence, the dialogue between banks and the government was restarted and the agreement reached was stipulated in a Minutes of Understanding on December 15. The agreement gave assistance to debtors, this time jointly with the government. This included the sharing by the government and the banks of the interest on the overflow account loan, the raising of the number of real estates to be purchased by the National Asset Management Company and the conversion into HUF and forgiveness of 25% of 90 days plus overdue loans. On the other hand, the agreement allowed banks to deduct 30% of the losses from the special bank tax). Furthermore, the banking sector was given a promise for the abolition of the special bank tax and for further tax deduction possibilities subject to the increase in lending activity.

### ***1.4 National Asset Management Company (NAMC)***

The National Asset Management Company was set up at the end of August. The NAMC is charged with purchasing the real estates of families with at least two children. (Pursuant to the December agreement with the government, the scope of eligible debtors has been extended to include families with one child). The Act on the NAMC was drafted in agreement with the Association. The legislation sets the purchase price as a percentage of the market price of the real estate on conclusion of the loan contract. The price purchase price will be 55% in Budapest and cities with county rights, 50% in other cities and 35% in other municipalities. First ranking mortgagees will receive a maximum of 80%, second ranking mortgagees a maximum of 50%, third ranking mortgagees a maximum of 25% and fourth and lower ranking mortgagees a maximum of 10% of the claim. The National Asset Management Company will purchase the real estates free of any liabilities/encumbrance. This means that the bank will have to forgive a part of its claim, but this will be up to the bank. If the bank does not approve the deal, the purchase will not take place. If the bank approves the deal, the NAMC will act as the bank's agent in the purchase contract. The rights and obligations of banks and the NAMC will be stipulated in a cooperation agreement. About 8,000 real estates are expected to be purchased by the NAMC in 2012.

### ***1.5 Accounting, taxation and reporting issues related to tackling the FX debtors' issue***

After drawn-out consultations, accounting issues related to the overflow account loan scheme introduced in the summer of 2011 were brought to a favourable conclusion. According to the initial

PSZÁF-MNB proposal, the overflow account loan and the underlying loan would have been considered as restructured and subject to provisioning, irrespective of the underlying loan's category. Also, the interest accumulated on the overflow account loan until commencement of the repayments from the end of 2014 would have been subject to 100% provisioning. Accepting our arguments, the relevant legislation provides that overflow account loans, where the underlying debt was rated as problem-free before entering the exchange rate protection scheme, will be reclassified into the restructured category, but will not be subject to provisioning. Also, the interest accumulated on the overflow accounts will not be subject to provisioning. (If all these had been subject to provisioning, the provisioning requirements would have meant several billions of forints in provisioning expenses for banks).

We conducted wide consultations with specialists from member bank on accounting issues related to the early repayment scheme with a view to developing a method to be consistently applied by all banks. Also, we requested the Hungarian Chamber of Auditors to provide banks guidance in interpreting these specifically Hungarian financial products in terms of the relevant Hungarian and international accounting standards.

Reviewing the changes in accounting rules related to the government's Home Protection Plan, we made several adjustment proposals to ensure consistent application of the rules for the treatment of early repayments and claims forgiven voluntarily by the banks, for the purpose of personal income tax, corporate and dividend taxes and other duties. Also, we requested and received rulings from the Ministry for National Economy on specific issues. There was also an example, where, upon our prompt action, the Ministry adjusted the relevant tax laws within two days.

Furthermore, we requested PSZÁF and the MNB to return to the sector the aggregate data of the weekly reports provided by banks on the early repayment scheme. The authorities published the requested aggregate data on a monthly basis. To be able to properly analyse and measure the impact of early repayments, we solicited from banks their relevant data and summarised and returned to them the aggregate data on a weekly basis. Banks found this action valuable and useful.

## **2. Corporate lending**

### ***2.1 SME lending***

The National Development Agency held a presentation at the Association on priorities and financing issue under the new Széchenyi Plan. We held several consultations with the Ministry for National Economy on possible measures against late or non-payments to subcontractors. Based on proposals from specialists from member banks, the Association submitted a proposal to prevent "tricks" with bank guarantees. Although the proposal was well-received by the Ministry, no decision was made until the closing date of this report.

There were also consultations on the introduction of a combined loan programme. At the Board's initiative, an expert group was set up, headed by László Balázs, Member of the Board. The expert group drafted a proposal for short and long-term measures to stimulate SME lending.

The Association initiated the revision of the SME loan reporting system, including the exclusion of data of organisations not belonging to this category. We agreed with PSZÁF and the Ministry for National Economy that from 2013, the reports will be filed according to the new system.



## ***2.2 Agricultural lending***

Working closely with the Ministry for Rural Development and the Agricultural and Rural Development Agency, we held several briefings and consultations on current issues related to agricultural lending. These included:

- the introduction of Széchenyi Cards,
- improving terms and conditions for food inventory financing,
- the rescheduling of working capital loans granted to agricultural producers under the New Hungary Working Capital Loan Programme,
- lending to young farmers,
- changes in the Agricultural Working Capital Loan Programme,
- issues related to the prefinancing of grants.

Also, the Ministry's State Secretary held a briefing on changes in agricultural support schemes and future plans.

We reiterated our proposals for amendments to the Warehousing Act. (Although this issue belongs to the Ministry for National Economy, more than 90% of those affected are agricultural businesses). Actions proposed by the specialist working group set up were implemented in cooperation with the Warehousing Authority and the Warehousing Association. Despite several consultations with the Ministry for Rural Development, the Warehousing Authority and the Warehousing Association, the drafting of the amendments did not commence until the closing date of this report. It is hoped that the draft amendment will be submitted to the Parliament in the first half of 2012.

We initiated several times the amendment of the cooperation agreement between banks and the National Land Fund. The Ministry agrees with the need to amend the agreement, but says this could only be done after adoption of the proposed amendment to the Land Act.

Based on comments from member banks, we provided comments on the Rural Development Ministry's programme for 2012-2020.

## ***2.3 Lending impacts of amendments to the Energy Act***

As a result of amendments to the Energy Act, the subsidy and pricing rules for combined heat and power plants have changed. According to analyses conducted by specialists from member banks, the affected power plants (some 190 in number) may be faced with serious financing problems. We held several consultations with the Ministry and power plant associations to explain the aspects of financeability. The maintenance of financeability is not just a banking issue: if, due to financial difficulties, a power plant is forced to shut down, whole communities, including households, businesses and public institutions would be left without services.

## **3. Project on municipalities**

The government seeks to reform the financing of municipalities. To promote cooperation between banks and the government, the Association set up a specialist high-level working group and a specialist team on municipalities in the spring of 2011. In mid-2011, the municipalities sector had a debt stock of HUF 1,000 billion (4-5% of GDP, which is equivalent to the EU average). More

than 50% of the stock of debt was in foreign currency. (Nearly 50% of the stock of debt was in bonds, 79% of which was denominated in Swiss Francs). Loan and bond repayments are due from 2011 and 2012. **The Interior Ministry developed a concept and a draft text for the new Municipalities Act.** Banks provided comments on these proposals in relation the following issues: **redirection of tax revenues from municipalities to the government, regulation of the redirection of assets, rescheduling of existing loans, issues related to the future account management of municipalities, future funding of municipalities, bankruptcy and debt settlement laws.**

Based on the decision of the Board, we sent our proposals to the competent government officers, the parliamentary groups, technical committees and leaders of municipality associations. The head and members of the High-Level Working Group reviewed the proposals on two occasions with officers of the Ministry of Interior and leaders of municipality associations. At the meeting held in December, the Interior Ministry's State Secretary said he would have welcomed a more detailed proposal to address municipality debts. The Association's position was that this issue should be addressed on a case-by-case basis: these are all individual cases and by far not all cases require restructuring, therefore, it would be inexpedient to talk about any general solution. During the meeting we learnt that municipalities will continue to be free to decide whether to have their account managed by the Hungarian State Treasury or by a commercial bank. We were also briefed that townships will not have accounts and municipalities will remain financially independent, with no compulsory single account. At the end of the meeting the State Secretary proposed that consultations between the Ministry and the Association should be continued on an ongoing basis.

#### **4. Implementation of the Act on Central Credit Bureau**

The Association had long proposed that the well-proven negative debtor list-based central credit information system be complemented with a positive debtor list. An opportunity for this arose in the autumn of 2011, when shortly after an announcement by the prime minister, the Parliament adopted the new Act on Central Credit Bureau. However, the new Act contained numerous basic errors, hindering implementation.

A project on Central Credit Bureau was set up by the Association from representatives from member banks and supported by BISZ. In its initial stage, the project focused on drafting amendment proposals to the Central Credit Bureau Act (to correct the errors in the Act), having the amendment proposals accepted by the Ministry responsible for drafting the legislation, and seeking temporary solutions to implement the impracticable provisions of the Act until the Act is amended.

The project's efforts were successful:

- Temporary best practices were developed and recommended to member banks, offering information and data processing solutions that can be managed preferably without infringing the letter of the law.
- At the beginning of November, the Act was amended basically in accordance with our proposals, providing manageable preparation and implementation deadlines, eliminating excessive reporting requirements (bank accounts, closed loan contracts) and enabling reasonable system management.
- With this initial work, the project has become a major setting for the development of a comprehensive credit bureau. As a result of activities of the working group
  - a sample customer information document was developed,
  - a recommendation for the method of customer consent for data inquiries was drafted,

- the contents of the data fields to be sent to the Central Credit Bureau were identified,
- a complex method for a single-step transfer (initial upload) of loan contracts into the Credit Information System was developed through professional consultations.

Regarding those provisions of the Act on Central Credit Bureau where no satisfactory solutions could be identified, rulings were requested from or amendment proposals were submitted to the Ministry responsible for drafting the legislation.

The project will continue in 2012 until the system becomes fully operable.

## **5. Success in the consultations on customer information on deposits covered by the National Deposit Insurance Fund (OBA) and on the OBA's fees**

The National Deposit Insurance Fund's Board sought to tighten the rules for customer information by providing that the information, which thus far has had to be provided only if so requested by the customer, should be issued by banks once a year on a mandatory basis.

The legal basis and rationale of this proposal were both questionable: the information in most cases is outdated by the time received by the customer. Furthermore, in terms of the typical size of the deposits, the information is irrelevant, since the ratio of deposits above the covered level is less than one percent. Also, the proposal ignored the customer's instruction as to whether he or she needed any information at all. In addition, the proposed new rules regarding the structuring of the data, the ensuing extra IT work, and the proposed method of delivery of the information would have imposed extra burdens on the banks, which have already sustained significant losses. The Association also pointed out that the relevant EU laws did not impose such requirements and the proposed measure was against a level playing field: branches of foreign banks were not required to issue these customer notifications.

We managed to convince the OBA Board to revoke the proposed decision. Accordingly, the information provision will continue to be subject to the customer's request in 2012.

As another important achievement, we managed to prevent an increase in the OBA fees for 2012 from 0.06 percent to 0.1 percent. The OBA had cited the proposed EU coverage level as the reason for the proposed increase. However, the relevant EU Directive is still under consultation and we do not believe Hungary should be a pioneer in introducing the proposed, and debated, requirements of the draft Directive. The Hungarian coverage level is not critical, anyway, compared to the requirement provided in the Draft directive. The Association's successful intervention on this issue means billions of forints in savings for the sector.

## **6. Regulations affecting credit institutions**

### ***6.1 Changes in the bankruptcy laws***

The Act on special rules for bankruptcy and liquidation proceedings for companies of national importance (Act CXV of 2011) was enacted in July. This provides that the liquidation of companies designated by the government as nationally important shall be managed by a state-owned liquidator rather than a liquidator registered in the liquidators' register. The company under liquidation will be entitled to an immediate payment moratorium and special rules will apply in a number of other respects as well. This is detrimental to creditors' rights, in terms of the right to sell the company's assets and the position of lien holding creditors. The new legislation has

amended the rules for composition without providing guarantees to protect creditors against fraudulent bankruptcy. The Association tried to enforce these aspects, but without success. Another amendment to the Bankruptcy Act, enacted by Act CXCVII of 2011, has replaced the category of "company of strategic importance" by the category "company of national economic importance" and further extended the already wide range of companies falling into this category. As is publicly known, the first such liquidation proceeding was instituted in 2012 and is now in process against the Hungarian national airlines.

A number of elements of the amendment to the Bankruptcy Act enacted by Act CXCVII of 2011 took effect as of March 1, 2011. The amendment has introduced a mandatory cancellation procedure for companies without assets or operations and amended the rules for liquidation proceedings with a view to strengthening the debt collection function of the proceeding. An electronic sales system has been introduced for the sale of debtors' assets. We submitted proposals for provisions to prevent fraudulent bankruptcies. We made proposals regarding the operation of the creditors' committee, disbursements during a bankruptcy moratorium and the implementation of bankruptcy agreements.

### ***6.2 Amendments to the Act on Judicial Distraint***

Act CLXXX of 2011, amending the Act on Judicial Distraint and other laws contained a number of provisions aimed to shorten the deadlines for the proceedings, increase the transparency of the proceedings, improve debt collection and promote electronic administration. The Act introduces an electronic system for the delivery of distraint documents effective July 1, 2012. Electronic communications will be mandatory also for bailiff requests to be sent to banks to identify the debtor's bank accounts. The rules for collection by administrative order will also change.

Thanks to the Association's submission of a comprehensive proposal for the proposed amendment, a number of our proposals were taken into account in the draft law. We provided several comments on the draft law itself and conducted consultations in relation to the ordering of distraint by notaries, real estate foreclosures, the rules for take-over by the party requesting the foreclosure after repeatedly unsuccessful auctions, the prevention of frauds, and the implementation of the provisions on payments.

### ***6.3 New Data Protection Act***

The new Act on informational autonomy and freedom of information (Act CXII of 2011) is aligned with the EU Data Protection Directive. In this context, new legal grounds for data processing have been introduced, in addition to the customer's consent and authorisation by law. The processing of personal data is now allowed even in the absence of legal authorisation or consent by the customer or, for example, if such data processing is necessary for protection of the rights of the data processor or third parties, or for meeting legal obligations, or in cases where the customer's consent is difficult to obtain. The institution of Data Protection Ombudsman has been abolished and replaced by the National Data Protection and Freedom of Information Authority, with a broadened scope of authority, including, for example, the right to fine.

The Association's competent working groups reviewed the new legislation with a view to supporting members' in preparing for the application of the new law. We initiated amendments with the Ministry for Administration and Justice and the Data Protection Authority to remove the provision on mandatory registration in the Data Protection Register. A new legal institution under

the Act is the Data Protection Officers' Conference. Data protection audits will be a new service provided by the new Authority.

#### ***6.4 The new Civil Code***

After revoking still before their entry into force the amendments previously adopted by the Parliament, the government in the summer of 2010 commissioned the Civil Law Codification Committee, headed by Lajos Vékás, to draft the new Civil Code. The draft, completed at the end of 2011, was submitted to the High-Level Codification Committee and the Ministry of Administration and Justice. The objective was to draft a new Code covering the widest possible range of private law relations. To achieve this, the provisions of the Family Act and the provisions on companies were incorporated in the proposed new Civil Code. The proposed Code covers the private law relations of market players, private persons and consumers. The December version of the Draft Code contained serious threats in terms of the provisions affecting credit institutions, including the narrowing of the scope of collaterals, the abolition of floating charge and independent lien and inconsistencies in the "Loan and Account Relations" chapter. In a letter to professor Vékás and the Ministry we drew attention to these issues and requested a consultation to explain our concerns in detail.

The draft of the new Civil Code is currently under review. It has been published on the Justice Ministry's website, comments are invited by March 31, 2012.

#### ***6.5 Notary fees***

We had several meetings with leaders of the Hungarian Chamber of Notaries on the issue of notary fees. A key issue was the fee charged for procedures instituted at a time against joint and several debtors. In these cases, some notaries were charging multiple fees (the fee for one debtor multiplied by the number of debtors). Bank had challenged this practice in courts, in most cases successfully. After lengthy discussions, a compromise agreement was reached: a fee of HUF 5,000 will be payable for the second and subsequent debtors, each, irrespective of the claim amount. We held further consultations on a reduced fee to be applied in the case of using a sample deed for contract amendments related to the government's debtor rescue scheme. Pursuant to the Decree on Notary Fees, the fee for contract amendments related to the overflow account loan is payable by the creditor bank. The Chamber of Notaries issued a guidance on notary fees and cost reimbursements. According to this, in the case of using the proposed sample deed, a notary fee of HUF 15,320 shall be charged (except if the deed is to be drawn up at the bank's premises, in which case a fee of HUF 23,720 shall be applied).

#### ***6.6 Ombudsman investigations***

The Civil Rights Ombudsman conducted investigations on several issues affecting banks. These included the following:

- the exercise of fundamental citizen rights in financial legal relations, in particular, in relation to responsible lending and unilateral contract amendments,
- legal representative's fees in judicial foreclosure proceedings,
- retrospective registration in the Land Registry of right-of-way to power lines,
- bailiff fees.

The Association provided detailed answers to these investigations, presenting the developments in legislation and the related banking practices. All investigations were concluded favourably, no

complaint on any banking practice breaching any fundamental citizen rights was raised by the Ombudsman.

The Ombudsman report No. AJB-2183/2010 on responsible lending and unilateral contract amendments was of special importance. The report did not contain any condemnation of banks. The report found that although the degree of customer information was inadequate, the relevant customer information requirements provided by law were excessively detailed, and therefore, counterproductive.

In the closing part of the report, the Ombudsman made proposals for a set of government measures, including the creation of a comprehensive credit information system, the development of a personal bankruptcy framework, and the portability of government home subsidies. He also proposed the simplification of customer information requirements, by narrowing them to the essential issues and invited the government to make the development of financial literacy a priority.

### ***6.7 Unilateral contract amendments: assistance to Partiscum XI Savings Cooperative in its litigation***

This litigation was launched upon a claim filed by the Csongrád County Chief Prosecutor's Office, which considered certain provisions relating to the unilateral amendment of contracts in the Business Terms and Conditions of Partiscum XI Savings Cooperative as unfair. After a verdict by the Szeged Court of Appeal, the Supreme Court adopted a partial verdict, ordering a new proceeding in respect of certain elements of the second instance verdict, while upholding others. The litigation started again. The Csongrád County Prosecutor's Office's motion, submitted at the invitation of the court, considered the conditions specified in the list of reasons in the savings cooperative's General Contract Terms and Conditions (which are based on the Code of Conduct adopted jointly by the Association, PSZÁF and the government) as parts of the normal business risks of banks, ones that may not serve as a ground for the unilateral amendment of a contract.

The Csongrád County Court heard the case on January 25, 2012. The Association provided professional assistance to the Savings Cooperative in the litigation. At Partiscum's request, our Secretary-General, Levente Kovács, University Head of Department, provided a written expert's opinion. In its verdict, the Court accepted the prosecution's motion, and, citing the Civil Code, declared (ignoring the relevant sector laws and the expert's opinion) that Partiscum's General Terms and Conditions were unfair, and therefore, null and void.

Partiscum expressed their thanks for our assistance and informed us that they would not seek legal remedy, as their relevant stock of contracts was minor (less than HUF 10 million). We sent the verdict to our Legal Working Group for their information.

## **7. Payments**

### ***7.1. Payments glossary***

In accordance with the Board's decision, work was started to create a payments glossary in Hungarian and English within the framework of self-regulation. The proposed glossary is aimed to eliminate misunderstandings arising from the divergent use of terms and may be a useful aid in the translation of EU legal documents. A project work plan, including the breakdown of tasks, organisational rules, the working methods and main milestones for the project was drawn up.

Based on the project tasks, a Steering Committee was set up. Members of the Steering Committee include representatives from the MNB and the Hungarian SEPA Association, the Association's Secretary-General and the head of the Association's Payments Working Group. The Steering Committee reviewed, adjusted and approved the project work plan. The Association requested members to appoint specialists to the various project working groups. The project working groups were set up and are supervised by members of the Steering Committee. The project is expected to be concluded in 2012.

### ***7.2 Basic bank account - self-regulation***

The European Commission in July issued a recommendation on access to a basic bank account. Pursuant to this, in any member state, consumers who are legally resident in the European Union and who do not hold a payment account in that member state should be in a position to open and use a basic payment account in that member state. The Ministry for National Economy requested the Association to implement the recommendation through a self-regulation. Accordingly, the Association's Basic Bank Account Working Group was reinstated. The Working Group drafted a Board Recommendation on the issue.

### ***7.3 Debate with the MNB regarding its cash distribution and processing regulation and fees***

With no agreement reached in 2010, the debate with the MNB regarding the mechanical processing of banknotes continued. In his response to the Association's letter, the MNB's Governor pointed out that MNB was determined to combat counterfeiting by using the most advanced means available. However, he expressed the MNB's willingness to take account of the results of a potential impact study or survey to be conducted before introducing the requirement of mechanical processing, entailing extra costs for banks.

We considered that it would not be expedient to continue to challenge the MNB's position of the need for automatic processing with a view to combating counterfeiting, nor would it be expedient or desirable to undertake a major, complex and costly, impact study. During the subsequent negotiations, agreement was finally reached: with a view to efficiently combating counterfeiting, branches with high cash transaction volumes may only be supplied with mechanically processed banknotes. Also, tills with high cash transaction volumes will have to be equipped with counterfeit detection lamps. To reduce the financial burden on banks, the required development projects may be implemented over a longer period of time. Branches and tills with low cash transaction volumes will be exempted from the above requirements. The relevant MNB Decree was issued after an appropriate review process in mid-2011.

During the summer, the MNB informed us about its plan to significantly increase its cash transaction fees for 2012. The MNB's objective in the fee increase was to ensure that only wholesale quantities are handled in cash trading between the MNB and banks and to promote cooperation between banks in organising small cash deliveries into larger lots.

The Association indicated that banks took note of the MNB's objective, however, such a major reorganisation in the cash market needed time. Based on a survey conducted among members, the Association's Cash Working Group developed a detailed proposal for the gradual restructuring of the market. The proposal contained new methods for interbank banknote trading, wholesale containerisation and on-site MNB depositories. We requested the MNB not to increase its fees until the proposal is implemented. However, the increased fees were introduced effective January

1, 2012. At the same time, at banks' initiative, the MNB launched consultations with banks on a review of the regulations on CIT companies and on-site MNB depositories.

#### **7.4 Bank cards**

At its regular monthly meetings, the Cards Working Group reviewed regulatory requirements related to bank card operations and the PSZÁF's CEO letter on expected bank card practices. The group also reviewed the latest market trends and ongoing development projects, including the introduction of chip cards and sticker-cards. To promote effective cooperation, the Working Group regularly invited specialists from the MNB and PSZÁF to its meetings in 2011.

The Association's weekly newsletter Bank Cards News, launched in September, is an increasingly popular information sharing tool.

At the beginning of December, it became obvious that the recent international data theft case affected several thousands of banks cards in Hungary. The Association acted promptly in getting the information to member banks and informing the public, and took all the necessary security measures in close cooperation with all bank card issuing banks. Cards likely to be affected were replaced in large numbers. Transactions were carefully monitored and banks made special preparations to inform customers and promptly manage the inconveniences caused by the incident. In addition, banks assumed the costs of the measures needed. As a result of swift and coordinated actions, card payments in Hungary remained undisturbed and safe during a busy year-end holiday season.

### **8. Taxation issues**

In addition to taxation issues related to the foreign currency debtor rescue schemes, the Association's Taxation Working Group conducted several consultations on other taxation issues with the Ministry for National Economy and the Tax Office in 2011. In early 2011, we addressed interpretation issues related to the tax amnesty for off-shore savings. The relevant legislation allowed private persons to disclose and repatriate their untaxed off-shore funds anonymously, at a preferential tax rate of 10%. An important aspect for the ten banks appointed by PSZÁF to manage these transactions was that their relevant processes and internal systems are developed in compliance with the Act on the prevention of money-laundering and terrorist financing.

We reviewed the proposed tax laws for 2012, presented to Parliament in the autumn. Inter alia, we drew attention to the lack of transitional provisions regarding the new taxation rules for R&D, which causes unclarity regarding the treatment of ongoing contracts spanning several years. In relation to the special bank tax, the taxation rules related to succession and mergers and acquisitions have changed. Here, we requested that the law is only applied from 2012 rather than retrospectively and provided text proposals to avoid double taxation in the case of de-mergers.

We took action to prevent the reinstatement of the revenue limit for tax exemption for leasing, an issue we had lobbied against for long and had managed to have a more simple system put in place. We also succeeded in relation to another proposal that would have caused increased administrative burdens in connection with non-financial contributions for business policy and marketing purposes. The relevant proposal was also dropped.



In accordance with our earlier request, a provision requiring the Tax Authority to publish the list of taxpayers availing themselves of the choice under Section 88 of the VAT Act was added to the Act on Taxation. This means that banks will no longer have to investigate and find out the VAT status of the debtor/mortgagee when it comes to the sale of the real estate. This will allow faster administration.

At an earlier initiative, the preferential interest tax/interest tax exemption for long-term private investments will be extended to foreign currency investments. We requested clarifications from the Ministry regarding practical issues related to implementation of the new regulations.

A new government programme was launched to reduce administration. An element of this programme is the simplification of taxation. Reducing the administrative burdens of businesses, in particular, those of SMEs, is a main priority of the programme. In addition to representatives from chambers and other interest representation organisations, the Association's Taxation Working Group is also represented in the Tax Simplification Working Group set up under the programme. We consider it important that the banking sector, as a key player in the collection of taxes is given a major role and banks' views are taken into account in the programme. To achieve this, we summarised banks' proposals and forwarded them to the government officers managing the working group.

## **9. Code of conduct for bank account switching**

The success of our self-regulation, providing for a simplified, one-stop process for bank account switching is reflected in the fact that out of 4,600 applications for bank account switching, 3,000 were successfully concluded in 2011.

## **10. PSZÁF consumer protection reporting requirements**

In addition to changes in the annual regular supervisory reporting requirements, consumer protection reporting requirements have also changed from 2011. The Supervisory Authority has interconnected its Deposit and Savings Product Selection Programme with its Loan and Leasing Product Selection Programme on its website. For this purpose, it has introduced a new online data transmission system. The new system, called ERA, has entailed changes in the relevant processes. The checking and maintenance of the data and adaptation of the reports to the new requirements posed extra tasks for all banks. During the relevant consultations, a number of issues were clarified and the implementation date of the new system was extended.

## **11. Remuneration policies**

In line with the relevant EU laws, an amendment to the Credit Institutions Act, taking effect on January 1, 2011, has set the framework for the remuneration of banking employees charged with risk-taking and risk management responsibilities. The Act has authorised the government to regulate the individual application of the law subject to the specifics of the affected institutions. Institutions had until May 31 to develop their own remuneration policies in line with the relevant provisions of the Act. This deadline was extended to August 31 through an amendment to the Act. The competent ministry charged PSZÁF with drafting the relevant government decree. PSZÁF reviewed its proposal on several occasions with the Association's Human Resource Working

Group. The government decree was issued rather late, on July 18, and after an amendment, took effect on September 30.

## **12. Supervisory and central bank reporting**

The structure of the legal framework for reporting has changed: the Supervisory Authority has been vested with decree rights and has taken over the relevant legislative tasks from the Ministry for National Economy.

At the beginning of the year, we submitted to the Supervisory Authority a set of amendment proposals to the Authority's proposed decree on reporting requirements on high remunerations. In accordance with the relevant EU laws, since May 31, 2011, credit institutions and financial enterprises have been required to report the number of those executive and employees whose annual remuneration is equal to or in excess of HUF 300 million.

In March, a consultation was launched on COREP and on the proposed reporting package for investment services. During the review of the proposed decrees we submitted a number of proposals and adjustments to make the provisions of the decree more specific. Again, the proposed changes required major IT developments. Accordingly, we requested that a three-month preparation time be allowed from the finalisation of the relevant decrees. The Supervisory Authority revised the initial proposal and extended the implementation date.

At the beginning of the summer (earlier than in the previous years), the MNB invited banks' specialists for a consultation on the proposed central bank reporting requirements for 2012. Pursuant to these, the common supervisory and central bank reports, mainly including balance sheets and profit-and-loss accounts will remain (to the satisfaction of banks), with some minor changes in the related reporting tables. The reporting tables will be extended with information aimed at monitoring retail loans, revaluation and interest rates. The MNB assessed the cost impacts of the proposed changes and the results of the assessment were taken into account in the new reporting requirements.

In addition to regular reporting, a number of special reporting requirements were imposed in 2011. The impacts of the exchange rate cap and early repayment schemes were monitored closely by PSZÁF and the MNB. In order to reduce the administrative burdens on banks, we requested the authorities to review the current reporting requirements and cancel, or at least suspend, the less important ones as long as the special reporting requirements are in effect.

Reporting officers are aware that further significant changes in reporting are expected from 2013 due to the uniform statistical requirements announced by the European Banking Authority (EBA).

## **13. Financial Arbitration Board**

Already during the review of the relevant draft law, we had expressed concerns about the legal status of the Financial Arbitration Board, in view of the fact that a quasi-judicial body has been incorporated into an executive agency, PSZÁF, which raises the issue of violation of the division of powers. Our concerns have, unfortunately, been justified by experience: using its consumer protection (administrative) powers, PSZÁF, on a regular basis, directly reacts to failures of banks turning to the Arbitration Board. In addition, it punishes even minor delays with disproportionately high fines, several times higher than the value of the disputed transaction. Our concerns have, unfortunately, been justified by experience: using its consumer protection (administrative) powers,

PSZÁF, on a regular basis, directly reacts to failures of banks turning to the Arbitration Board. In addition, it punishes even minor delays with disproportionately high fines, several times higher than the value of the disputed transaction.

## **14. Miscellaneous**

### ***14.1 Measures against consumer groups***

Following an article published in the Association's E-Newsletter, the Hungarian Financial Supervisory Authority's Market Supervision Department invited us to a consultation, where we reviewed the possibilities for eliminating businesses that are not illegal but are not subject to supervision and often cause damages to customers.

### ***14.2 Red sludge victim borrowers***

The owners of mortgaged real estates damaged or designated for demolition in the wake of the red sludge disaster were treated equitably by all banks, many banks forgave a part or whole of the debt.

### ***14.3 PSZÁF methodology guide on internet banking security***

PSZÁF sought to issue a methodology guide on internet banking security in July. The proposed guide had not been consulted on with banks. Upon the intervention of the Association's IT Security Working Group, PSZÁF postponed the issue of the guide and, with a view to adjusting it, prepared a questionnaire, soliciting information from banks' IT officers on security measures in place at their banks. The revised guide was completed on September 23. PSZÁF and the Association's IT Security Working Group agreed the proposal in October. The final guide was issued on October 25.

### ***14.4 Bank robbery statistics***

The Association's Human and Physical Security Working Group held two meetings with representatives from the National Police Headquarters to review the statistics on bank robberies in Hungary. The main conclusion of these meetings was that the number of bank robberies has decreased significantly since 2009 and 2010 and is now at the rate it was before the financial crisis.

### **III. International relations, Association events, communications**

#### **1. European Banking Federation**

##### *1.1 EBF activities related to regulation*

###### *1.1.1 Global and European regulations*

In relation to global and EU regulatory endeavours, the EBF consistently represented and communicated the following principles:

- impact studies are needed to assess the cumulative impacts of the proposed regulations in terms of both contents and implementation schedule.
- the proposed regulations should ensure a level playing field in Europe and globally.

The EBF's lobbying activities in relation to regulation were focused on the following issues in 2011:

#### **A) Bazel III –CRD4/CRR\***

The Basel Committee published several documents in 2011 to fine-tune the Basel III framework. The European Commission published its proposed regulatory package for Basel III implementation in July (/CRD4/CRR). The EBF submitted several amendment proposals to the proposed regulations and gave the top ten priorities where it would like to see changes in the regulations.

#### **B) Regulations on strategically important financial institutions (SIFIs, G-SIBs)\***

In July, the Basel Committee issued a consultative document setting out measures for global systemically important banks. During the consultation, the EBF gave a detailed criticism of the proposal and pointed out that additional capital could not be the only answer to systemic risk in globally important banks: improved risk management practices and governance are central to systemic risk prevention.

#### **C) Bank resolution frameworks\***

In July, the Financial Stability Board published a consultation document on effective resolution of systemically important financial institutions. The EBF supported the overall approach of the proposed regulation. At the same time, it emphasised the importance of consistent application of the regulation across all jurisdiction, and for supervisory intervention to be based on defined events, subject to objective and predictable measures, proportional, transparent, accountable and globally balanced.

#### **D) European Commission proposal for the recapitalisation of banks\***

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\* A more detailed report on the prudential issues marked "\*" is provided in the Annex hereto.

On October 12, the European Commission published a proposal to strengthen the capitalisation of European banks, requiring banks to establish a buffer such that the Core Tier 1 capital ratio reaches 9%. In response to the proposal, the EBF turned in a letter to the President of the European Commission and the President of the European Council. The letter pointed out that according to the last stress test, the capitalisation of European banks was strong and a new stress test by the EBA to determine banks' capital needs based on the market value of sovereign debts may have a negative impact. The EBF emphasised that banks applied the current legal requirements and could not be held to account for future capital requirements.

#### **E) Financial Transaction Tax (FTT)**

The European Commission in September published a draft Directive calling for the introduction of a Financial Transaction Tax. The EBF rejected the proposal as it could shift business to elsewhere in the world, with negative impacts on the funding of the European economy and on employment. A Financial Transactions Tax would also have an impact on the liquidity of instruments. The EBF stressed that the FTT was unsuitable for achieving the goals set in the proposal. The European Council rejected the request to discuss the proposal under urgency, however, it requested a progress report on FTT implementation from the European Commission and ECOFIN by June 2012.

The EBF set up a Financial Sector Tax Working Group to provide convincing arguments against the implementation of a Financial Transaction Tax.

#### **F) Proposed EU Directive on mortgage lending**

After several years of drafting, the European Commission published a proposal for a directive on mortgage lending. As is the case with the Consumer Credit Directive, the proposal covers the entire lending process.

The EBF provided comments and proposals on the following issues: the scope of the proposed Directive, the automatic rejection of loan applications of customers with negative credit ratings, the requirement to identify products that are not unsuitable for the consumer (*the criteria for assessing the creditworthiness of the consumer*) and the consumer's best interests (*best available terms and conditions*), the definition of provision of advice, the provisions related to banks' right to compensation for early repayment, restrictions on the components of the annual percentage rate of charge and the powers delegated to the Commission. The European Parliament's Internal Market Committee and the European Council supported a number of the EBF's proposals (the proposals regarding the rejection of loan application, components of the APR and the powers delegated to the Commission).

#### **G) MiFID review**

The European Commission published the proposed revision to MiFID in October. The EBF gave its comments and position in December. These are now under review based on a detailed consultation-advisory plan.

#### **H) Regulation on a SEPA migration end date, review of the EPC governance**

The European Commission published its proposed regulation on SEPA implementation in December 2010. The EBF expressed its view that the scope of application of the proposed regulation should be made more specific and the regulation should only be applied to credit

transfers and direct debits, with a single end date. It also proposed that the Commission's mandate should be narrowed and the technical details of the proposal should be aligned with the current SEPA standards.

In parallel with the publication of the proposed regulation, the European Commission's DG Competition reviewed the EPC's operations. Certain organisations expressed their criticism of the EPC for not being involved in its activities. Members also raised that the future role of the EPC should be reviewed and its governance system redesigned accordingly. The issue is expected to be decided in early 2012.

### ***1.2 EBF meetings in Budapest***

The European Banking Federation traditionally holds its board meetings in the member state holding the EU presidency. Accordingly, the EBF Board and Executive Committee held their meetings in April in Budapest. The meetings were chaired for the first time by the EBF's new President, Christian Clausen. During the informal events accompanying the meetings, leading officers of the European banking community could obtain information on the Hungarian banking sector and on current issues affecting the sector.

In keeping with the above tradition, the Association hosted a number of other EBF committee meetings. At these meetings, also attended by external presenters, participants received first-hand information on experiences and plans of the Hungarian presidency and specifics of the Hungarian banking market.

- At the **EBF Payments Systems Committee** meeting, the representative from the Ministry for National Economy gave a presentation on EU regulations related to SEPA and the Director of the MNB held a presentation on the introduction of intraday settlements in Hungary.
- At the **Anti-Money Laundering and Anti-Fraud Committee** meeting, a specialist from Citibank gave a presentation on the security of card transactions in Hungary.
- At the **Consumer Affairs Committee** meeting, a specialist from the Ministry for National Economy held a presentation on current EU consumer protection regulations.
- At the Physical Security Working Group's meeting the head of Crime Prevention Department of the National Police Headquarters gave a briefing on accomplishments and issues in the area of bank security.
- **The EBF Fiscal Committee** visited Budapest in early February to exchange views with representatives of the Hungarian government on taxation issues affecting banks in Europe and on the Hungarian government's plans. The discussions were focused on the long-discussed modernisation of the VAT Directive, but the EBF delegates took the opportunity to seek information on other issues, as well. The EBF delegates also touched upon the issue of a European bank tax, pointing out that this would put the European banking sector at a competitive disadvantage to other sectors and to non-European banks. Regulatory restrictions affecting the banking sector put an extremely heavy burden on the banking sector and the changes, such as the new capital adequacy framework, the increased reporting requirements, new accounting standards (IAS 39 replaced by IFRS 9, with more stringent valuation and impairment rules) and the FATCA in the U.S. Hence, the issue of bank tax should be addresses in a complex way.

Following the meetings, the EBF Committees expressed their thanks for the organisation of both the professional and the informal programmes.

### ***1.3 Other relations, consultations***

Strengthening international relations was a priority in the Association's operations in 2011 as well. As was the case in 2010, a number of issues in connection with the special bank required consultations at the international level. Several national banking associations as well as the European Banking Federation solicited information on the proposed Early Repayment Act and later on the final Act in the context of foreign parents of Hungarian banks turning to the European Commission and the EBF requesting in writing that the Act not be adopted and implemented<sup>1</sup>. We received inquiries on these and other issues from diplomatic corps in Hungary (e.g., the French, German, Korean, Polish., U.K. and U.S. embassies).

There was an important change in the European Banking Federation's Director and Executive Committee Chair positions. The new leaders brought fundamental changes to the procedures of the EBF, increasing activity and giving more emphasis to strategic issues. New strategic principles were developed and adopted for the Executive Committee and the Secretariat. Accordingly, the committees supporting the EBF central organisation were split up into strategic and technical advisory bodies.

Under the new setup, the EBF Communications Committee (chaired by our János Müller) was given a strategic role. Accordingly, it was requested to develop a proposal for the priorities to support the EBF's communications strategy and the contents of the communications.

### ***1.4 Global and European regulation***

#### ***1.4.1 EU self-regulatory initiative on transparency and comparability of bank fees***

The draft of the proposed EU self-regulation on the comparability of bank account fees, coordinated by the (EBIC<sup>2</sup>) was completed. The two sponsors, the European Commission and the EU Consumers' Organisation (BEUC) expressed serious criticisms of the initial June proposal as well as of the revised August and November versions. As a consequence, the European Commission decided to draft a proposal for legislation.

#### ***1.4.2 Prime Collateralised Securities (PCS)***

The EBF supported the industry initiative developed in cooperation with EFR and AFME in 2009 to revitalise the securitisation market. The gist of this initiative is the issue of certified asset backed securities (ABSs) that are widely accepted by investors and can provide finance for the issuers. PCS compliant issues would receive the PCS label from an independent PCS Secretariat. The certification would not substitute credit analysis and pre-issue due diligence, it would be a label telling investors that the securities are compliant with agreed common principles of quality, transparency, simplicity/standardisation and liquidity.

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<sup>1</sup> The EBF Secretary-General on October 19 wrote a letter to the Hungarian Prime Minister, Viktor Orbán, arguing against the implementation of the Act. The EBF Secretary-General emphasised that in view of the previous regulatory measures taken by Hungary and the EU, the Act would not promote stability or consumer protection. The letter described in detail the negative impacts of the proposed early repayment scheme.

<sup>2</sup> The European Banking Industry Committee is a common platform of European associations representing the banking industry

## **2. Domestic relations, conferences**

### ***2.1 Partnership agreements with ministries***

In line with Act CXXXI of 2010 on public participation in the drafting of legislation, we initiated the development of strategic partnership agreements with the Ministry for National Economy, the Ministry of Administration and Justice, the Ministry for Rural Development, the Ministry for National Development and the Ministry for National Resources.

In a separate letter, we requested the Ministry of Administration and Justice's Ministerial Commissioner responsible for drafting the new Civil Code, Dr László Székely, to involve the Association in the review process.

We received encouraging responses from the organisations approached. The Association concluded partnership agreements with the Hungarian Financial Supervisory Authority and the National Deposit Insurance Fund.

### ***2.2 Liaison with fellow associations***

Liaison with fellow associations has an increased importance in the current situation. The Association regularly liaises at both the management and specialist levels with the Association of Hungarian Insurance Companies, the Hungarian Leasing Association, the Hungarian Factoring Association, the National Association of Financial Enterprises, the Association of Securities Dealers and the Hungarian Association of Insolvency Practitioners and Asset Controllers.

Furthermore, we engage on issues of common interest as and when necessary with the Hungarian Chamber of Notaries and the Hungarian Chamber of Bailiffs.

### ***2.3 Cooperation agreement with the National Police Headquarters***

The Association renewed its cooperation agreement signed in 2004 with the National Police Headquarters. The agreement gives increased emphasis to physical security, other frauds and IT security issues.

### ***2.4 FATCA conference***

On June 22, the Association held a conference in cooperation with Hungarian and foreign experts from Deloitte on the requirements of the U.S. Foreign Account Tax Compliance Act (FATCA). The conference was also attended by specialists from PSZÁF and the Ministry for National Economy were also invited.

The FATCA is aimed to prevent tax avoidance by U.S. citizens by allowing the IRS to identify funds held by U.S. citizens on foreign accounts. From January 1, 2013, foreign financial service providers failing to enter into an agreement with the IRS and report U.S. source payments will be subject to a 30% withholding tax on all payments made. Preparations for compliance with the FATCA will entail significant work and costs for all non-U.S. financial institutions, including banks in Hungary. Foreign financial institutions should register with the IRS by June 30, 2013.

### ***2.5 Conference on 2012 tax law changes***

In keeping with the tradition of previous years, we organised a seminar for banks' taxation officers on major tax law changes affecting the sector, in cooperation with Deloitte. Participants heard



presentations on main tax changes taking effect in 2012 (personal income tax, corporate tax, bank tax, VAT, duties, social security contributions). The presenters also reviewed major accounting changes in 2012.

### ***2.6 Accounting conference for banks' lending and risk management officers***

At the end of April, the Association organised a conference in cooperation with KPMG for banks' lending and risk management officers to help banks in interpreting borrowers' IFRS and Hungarian financial statements. The conference was aimed to address issues and financial transactions where the financial report does not fully reflect the actual risks involved in the various operations of the company. Consultants experienced in international accounting say the Hungarian Accounting Act is in a number of points not clear enough and the Hungarian accounting rules do not always reflect the underlying risks. Experience shows that banks' analysts have problems in interpreting the IFRS reports regarding certain items and in recognising the actual contents of the relevant disclosures, accounts and related risks. The conference was focused on critical accounting issues related to investment project contracts and trading house transactions.

## **3. Communications**

### ***3.1 Main focuses of the Association's communications in 2011***

Developments in 2011 required intense communications work from the Association. Our communications were focused on the situation created by the adverse external and internal conditions in the banking sector and, in this context, the high number of legislative and regulatory changes. We had to respond to the 2011 impacts of the special bank tax, the suspension of the eviction and auctioning moratoriums and the Home Protection Act, which was enacted in the wake of the suspension of the moratoriums and introduced an exchange rate cap scheme for debtors with foreign currency denominated mortgage loans from August 12. Soon after this, on September 9, the early repayment scheme was announced, followed by the relevant Act. These were followed by the agreement signed between the Association and the Government on December 15. In this situation, the focuses for our communications virtually changed on a daily basis. We had to respond to the ongoing legislative and regulatory changes to protect the interests of the banking sector and provide political and economic decision-makers with convincing arguments. In respect of the customers, all this had to be communicated in a straightforward way, with professional arguments.

### ***3.2 Media appearances, press statistics***

The Association appeared on a daily basis in virtually all major media channels. However, this is not how we wish to describe the efficiency of our communications. In building our media relations, being constantly available for all the leading financial and business journalists, providing them with background information and setting up the Association's Press Club, we reached a situation where the press conveyed our messages without any distortion and with empathy for the problems, burdens and losses sustained by the sector.

An important change in the Association's media communications was that the Association's President, Secretary-General and Members of the Board in charge of the various issues addressed all key issues commensurately and with adequate frequency in the media.

### ***3.3 Press Club***

To ensure regular and efficient communications with the press, the Association set up a forum, meeting normally on a monthly basis, to discuss financial and banking issues. Participants in the forum include leading financial journalists from the electronic and print media.

### ***3.4 Customer information***

With the problems arisen lately in retail banking services, the number of customer complaints and information requests increased significantly in 2011. We had to address all individual complaints and requests, even though remedying the complaints or providing advice is out of the Association's scope of competence. We answered hundreds of customer approaches, many in writing and many more orally. What made the situation even more difficult was the lack of customers' awareness of the fact that it is PSZÁF that is the organisation authorised by law to address complaints and consumer protection issues related to financial institutions.

### ***3.5 Hitelintézeti szemle (Credit Institutions Review)***

During its nearly decade of history, our Hitelintézeti Szemle has grown into a recognised professional scientific periodical of the financial industry. The thematic edition of the periodical, addressing the theme "Risk, Uncertainty, Probability", was produced with contributions by prominent authors. The periodical's Editorial Board was joined by three new recognised economic scientists in 2011.

Upon the Editorial Board's decision, we identified a range of sponsors, including universities and doctoral schools. Through the selection of outstanding master's essays and scientific works, this cooperation will provide high-quality supplementary material for future editions of the periodical.

To ensure that the publication is efficiently distributed to all those interested and to reach the right professional target groups and actual decision-makers, our distribution list was reviewed and new principles for the scope of recipients were defined in the second half of 2011. Accordingly, the share of the scientific community, the media, background institutions and fellow organisations will increase among the recipients of the periodical (through somewhat increasing the number of copies and using the Association's inventories). The periodical is published in 1,000 copies.

## ANNEX

### **International developments: prudential regulation, supervision**

Global and European financial regulatory work in 2011 was characterised by the development of detailed proposals to address the challenges arisen in the wake of the economic crisis: the work of previous years was continued. Regulatory endeavours continued to be focused on strengthening banks' capital and liquidity standards, tackling bank crises and systemically important financial institutions, the regulations on central counterparties and on OTC derivatives and the enhancement of supervisory practices.

The Association's annual report is not the forum for presenting all the many regulatory initiatives and proposals in detail (this was done in the annexes to our quarterly reports). In this report we will only focus on the most important ones.

#### **I. Strengthening banks' capital and liquidity standards**

##### ***I.1. Basel Committee on Banking Supervision (BCBS) - Fine-tuning Basel III***

At the beginning of June, the Basel Committee published the *revised version of the Basel III framework*. This contained minor modifications compared to the original version, published in December 2010. The Committee reviewed and finalised the requirements for counterparty risk. The review resulted in a minor modification of the Credit Valuation Adjustment, as the impact study completed in the first quarter of 2011 showed that the standardised method as originally set out in the December 2010 rules text could be unduly punitive for low-rated counterparties with long maturity transactions. To narrow the gap between the capital required for CCC-rated counterparties under the standardised and the advanced methods, the Basel Committee reduced the weight applied to CCC-rated counterparties from 18% to 10%.

At the beginning of November, the Basel Committee published its second consultation paper on *capitalisation of bank exposures to central counterparties (CCPs)*. The second consultation document only contained minor changes compared to the December 2010 version. The Committee believes that appropriate capitalisation is an additional measure to address systemic interconnectedness. The proposal addresses trade exposures to central counterparties (providing a 2% risk weight for qualifying CCPs and a general 8% risk weight for non-qualifying CCPs) as well as the capital requirements for default funds.

The Basel Committee evaluated the impact of the Basel capital framework on trade finance and in October published its solution proposals to promote trade with low income countries. In consultation with the World Bank, the World Trade Organisation and the International Chamber of Commerce, the Committee adopted two technical changes to the Basel capital adequacy framework in relation to the treatment of trade finance, waiving the one-year maturity floor for certain trade finance instruments under the advanced internal ratings-based approach (AIRB) for credit risk, and waiving the sovereign floor for certain trade-finance related claims on banks using the standardised approach for credit risk.

In addition to the above adjustments, the Basel Committee drafted a number of other proposals to promote consistent implementation of the Basel III framework. At the end of December, the Basel Committee published a consultative document on *capital disclosure requirements*, aimed to

improve the transparency and comparability of a bank's capital base. In another consultative document the Basel Committee addressed the application of *own credit risk adjustments* to derivatives and securities financing transactions.

Updating its 2003 paper, the Basel Committee further developed its sound practices for the management and supervision of operational risk and its *supervisory guidelines for the Advanced Measurement Approaches (AMA)*.

In October, the Basel Committee issued a report on its members' progress in adopting Basel II, Basel II.5 and Basel III, as of end September 2011. The Committee plans to provide similar status reports on a regular basis to ensure that its capital standards are transformed into national law or regulation according to the internationally agreed timeframes. The Committee has developed a comprehensive framework to monitor members' implementation of the Basel regulatory capital framework. The objective is to review the consistency of members' national rules or regulations with the international minimum standard and identify differences that could raise prudential or level playing field concerns.

### ***1.2 Amendments to the EU capital requirements regulations (CRR/CRD4) - Single European Rule Book***

At the end of July, the European Commission published its regulatory proposals for the implementation of the Basel III capital framework in Europe. While fully respecting the Basel III rules, the proposal is mindful of certain European specifics (e.g., in relation to the definition of capital, the home/host aspect in the context of liquidity standards, and grandfathering).

Pursuant to the European Commission's decision, the capital requirements for banking and investment activities will be regulated in the form of a Directive (CRD4 ) and a Regulation (CRR). Licensing (minimum capital requirements), supervisory cooperation and information exchange, the framework for consolidated supervision, including liquidity oversight and the roles of auditors will be regulated by the *Directive*. CRD4 reinforces the powers of consolidated supervisors. In home-host disputes concerning capital and liquidity requirements or liquidity subgroup, the EBA<sup>3</sup>'s decision will be binding.

New elements in the Directive include provisions on sanctions, effective corporate governance and provisions preventing over-reliance on external credit ratings (requiring banks to develop and use of internal rating models). Out of the key elements of Basel III, the Directive includes rules requiring the maintenance of capital conservation and countercyclical capital buffers<sup>4</sup>. Institutions failing to meet these capital buffer requirements will be subject to restrictions.

The prudential requirements of Basel III (except for those related to capital buffers) are provided by the CRR. Providing prudential requirement in the form of a Regulation, directly applicable in all member states, ensures a level playing field by preventing diverging national requirements. A Regulation also enables the EU to implement any future changes more quickly (amendments can apply virtually immediately after adoption).

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<sup>3</sup> European Banking Authority

<sup>4</sup> Institutions are required to build up, in good times, a capital conservation buffer of Common Equity Tier 1 capital equivalent to 2.5% of their total risk weighted assets (RWA). Countercyclical capital buffers (0-2.5% of RWA) are set by national regulators to prevent high credit growth. The ESRB may give, by way of recommendations, guidance on setting countercyclical buffer rates.

**Early implementation of provisions of the Regulation will be a national discretion.** At the same time, the Commission is committed to the introduction of **Single European Rule Book**. The CRR removes all national options and discretions. Some specific well-defined areas, where divergences are driven by risk assessment considerations, market or product specificities and member states' legal frameworks, are exempted, allowing member states to adopt stricter rules. The proposal contains three possibilities for competent authorities to address macro-prudential concerns at the national level: adjusting the capital requirements for lending secured by immovable property, imposing additional capital requirements to individual institutions or groups of institutions where justified by specific circumstances under Pillar 2, and setting the level of the countercyclical capital buffer.

The proposed Regulation provides a more specific definition of capital, in accordance with Basel III. It addresses securitisation and trading book exposures, sets capital requirements for counterparty credit risk associated with OTC derivatives and introduces liquidity requirements consistent with the relevant requirements of Basel III<sup>5</sup>. In line with Basel III, there will be no mandatory leverage ratio requirement in the initial stage<sup>6</sup>. The CRR, disregarding the principle of sensitivity, extends the Basel I capital floor of 80% until 2015. At the same time, it provides for a better recognition of credit risk mitigation techniques. The new regulation also addresses the powers of the European Commission and the EBA.

A public hearing on the proposed Capital Requirements Directive and Regulation (CRD4/CRR) was held in October. Following the public hearing, the EP rapporteur published his proposals regarding CRR and CRD4 at the end of December. In January 2012, the Danish presidency issued a compromise proposal, providing more scope for national options and discretions. According to information, the Danish presidency would like to have the final text adopted by the Council in the spring and agreed on with the Parliament in June.

Preparations for the introduction of the capital requirements in Europe include the review of the **regulation of Credit Rating Agencies** (ESMA<sup>7</sup> consultation on the endorsement regime for CRAs, European Commission consultation on amending Regulation 1060/2009/EC on credit rating agencies and the review of COREP<sup>8</sup>).

### **1.3 Impact studies**

Several impact studies (European Commission, EBA, IIF) were conducted to quantify the **impacts on lending and on the real economy** of Basel III and the European laws implementing it. The results were often basically conflicting and unable to agree even on whether or not increased financial stability, which would increase GDP in the long-term, overrode the economic costs (the increase in the costs of access to capital and financing, the decline in lending activity, etc). What seems to be certain is that the introduction of liquidity ratios will increase banks' additional funding requirements by an amount in the range of a billion euros. According to an IIF research, the

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<sup>5</sup> The Liquidity Coverage Ratio (LCR) shall be reported from 2013 and applied from 2015. The Commission seeks to reach a minimum standard on the Net Stable Funding Requirement by January 1, 2018. However, institutions will be required to report their NSFRs already during the observation period.

<sup>6</sup> The proposed non-risk based leverage ratio will be subject to an observation period from January 1, 2013 to January 1, 2017. Institutions should disclose their leverage ratios from January 1, 2015 and the leverage ratio is expected to be introduced as a binding requirement from 2018, based on appropriate review and calibration. During the observation period, credit institutions and investment firms should monitor the level and changes in the leverage ratio as well as leverage risk as part of the internal capital adequacy assessment process (ICAAP) under Pillar 2.

<sup>7</sup> ESMA: European Securities and Markets Authority

<sup>8</sup> Common Reporting Framework

assumption that banks can access the funding required for the additional capital and liquidity requirements at low costs is not realistic, either. Industry critics point out that most impact studies fail to quantify the combined effect of the proposed introduction of the various new rules nearly at the same time (increased capital and liquidity requirements, special taxes, SIFIs, crisis resolution, deposit guarantee schemes, restrictions on activities, etc.).

#### ***1.4 Industry positions***

Already before the issue of the draft regulations in July, the European Banking Federation (EBF) had made active efforts to influence rulemaking at both the global and the European levels. The EBF drew attention to the negative real economic impacts of an overly restrictive prudential regulation and pointed out certain European specificities which ought to be taken into account with a view to preserving competitiveness. In its high-level letter to the Polish presidency, the EBF specified some key principles that should be followed in drafting the regulation:

- The cumulative impact of the new measures cannot be ignored
- The competitive position of the European industry should not be put at risk
- CRD 4 should refrain from creating new competitive distortions across the EU
- The new liquidity framework should be tested
- An appropriate timetable should be set for implementation

The EBF also drew attention to the potential negative impacts of the new regulation on trade finance (export credit) and indirectly, on global trade and on the global economy as a whole.

The EBF provided detailed comments and proposals on the European Commission's July CRD4/CRR drafts and submitted amendment proposals, listing *top ten priorities*, including the recognition of minority interest, the application of the Basel I floors, the application of liquidity requirements at the consolidated group level, the recognition of central bank eligible assets in the liquidity buffer, the operational requirements for holdings of liquid assets, the treatment of outflows of corporate deposits, the 75% cap on inflows, the treatment proposed for SME lending, the consistent treatment of software as in other jurisdictions and disclosure of the leverage ratio.

The EBF is firmly committed to the Single European Rule Book and does not support any endeavours to broaden the scope for national discretions and options. The EBF considers it important for the European Union to tie the introduction of the new regulations in Europe to their global implementation (in particular, in the United States).

#### ***1.5 U.S. developments – EBF request for the postponement of CRD 3 implementation***

The U.S. regulatory and supervisory agencies are in principle committed to implementing the previous Basel decisions (capital requirements for the trading book and securitisation) and the Basel III package. However, their implementation is hampered by the Dodd-Frank Act prohibiting the use of external ratings. Changing the Dodd-Frank Act is unlikely under the current Congress, hence, implementation of the Basel decision is expected to be delayed. Accordingly, the EBF president wrote a letter to the EU Commissioner on Internal Market, asking for the postponement of the planned implementation of CRD3 (Basel II.5) from January 2012, or European banks would be put at a competitive disadvantage, as the tightened capital requirements for trading book and securitisation exposures would significantly impact institutions' market making capacity. If CRD3 is implemented, European banks will have no choice but to cut back on their sovereign bond and securities inventories. In his response, while acknowledging the risk of regulatory arbitrage due to the uncertainty over the implementation of the Basel III rules in the U.S., the EU Commissioner did not see a realistic chance for postponing the implementation of CRD3.

In November, the U.S. regulatory agencies published for consultation a proposed regulation, which (subject to some narrow exceptions) prohibits banks from

- engaging in short-term proprietary trading of any security, derivative, and certain other financial instruments for a banking entity's own account,
- owning, sponsoring, or having certain relationships with, a hedge fund or private equity fund.

### *1.6 EU proposals for the recapitalisation of banks*

It can be observed that that some politicians and regulatory authorities tend to respond to the crisis by proposing the immediate strengthening of banks' capital positions even before implementation of the Basel III framework. On the basis of the results of its 2011 EU-wide stress test, the EBA issued its first formal recommendation stating that national supervisory authorities should require banks whose Core Tier 1 capital ratio (CT1R) falls below the 5% threshold to promptly remedy their capital shortfall.

Following an agreement reached in the ECOFIN in October in response to the deepening Greek crisis and the ensuing crisis of the euro, the EBA issued a communication on proposed EU measures to restore confidence in the banking sector. The communication addresses the issue of meeting banks' short-term funding needs at reasonable conditions. (In developing these conditions, the EBA will work with the European Commission, the ECB and the European Investment Bank). Pursuant to the EBA's capital package, banks are required to strengthen their capital positions by building up a temporary capital buffer against sovereign debt exposures. In addition, banks are required to establish a buffer such that the Core Tier 1 capital ratio reaches 9%. Banks are expected to build these buffers by the end of June 2012. According to EBA estimates published in December, based on September figures, the capital shortfall in the European banking sector, including sovereign buffer was EUR 115 billion.

In its press release on the proposed measures, the EBF welcomed the EU decision towards solving the difficulties related to sovereign debts. The EBF emphasised that the current crisis was predominantly a sovereign debt crisis, not a banking crisis. The 50% nominal discount on the Greek debt was a huge burden on banks and the extra capitalisation of banks to a Core Tier 1 ratio of 9% was another substantial demand placed on banks, which went beyond the initial plans put forward by regulators. Accelerating the tighter requirements may lead to banks adapting by reducing the denominator (that is, lending capacity) rather than increasing the numerator of the capital adequacy ratio.

## **II. Regulations on strategically important financial institutions (SIFIs<sup>9</sup>, G-SIBs<sup>10</sup>) - Bank resolution frameworks**

### *II.1 Regulations on strategically important financial institutions (SIFIs, G-SIBs)*

In July, the Basel Committee, issued a **consultative document setting out measures for global systemically important banks (G-SIBs)**. These measures include the methodology for assessing systemic importance, the additional required loss absorbency and the arrangements by which they

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<sup>9</sup> Systemically Important Financial Institutions

<sup>10</sup> Global Systemically Important Banks

will be phased in. The document, titled "*Global systemically important banks: Assessment methodology and the additional loss absorbency requirement*" will be submitted to the Financial Stability Board (FSB), which is coordinating the overall set of measures to reduce the moral hazard posed by global systemically important financial institutions.

(Also, a joint assessment of the Basel Committee and the FSB on the macroeconomic impact of higher loss absorbency for G-SIBs was published in October).

The broad aim of the regulation of global systemically important banks is to:

- reduce the probability of failure of G-SIBs by increasing their going-concern loss absorbency; and
- reduce the impact of failure of G-SIBs, by improving global recovery and resolution frameworks

The Basel Committee's proposals address the first objective of requiring ***additional going-concern loss absorbency*** for G-SIBs, thereby reducing the probability of failure. The Committee proposes to provide an additional loss absorbency requirement between 1.0% and 2.5%, depending on the systemic importance of the bank. A 3.5% additional loss absorbency requirement may be imposed on banks in the highest capital requirement category (to discourage banks from material growth). The additional loss absorbency requirement will be introduced in parallel with the capital conservation and countercyclical buffers, i.e. between January 1, 2016 and year-end 2018, becoming fully effective on January 1, 2019.

In the EBF's opinion, additional capital is not the right answer. A bank resolution framework may be the best solution to prevent contagion, one of the main forms of systemic risk.

In October, the FSB published a consultation paper a common reporting template for G-SIBs. The consultation paper identifies the key information gaps (concentration risk, market risk, funding risk, contagion/spill-over risk and sovereign risk) and provides proposals for the types of information to be collected.

## ***II.2 Bank resolution frameworks***

In January, the European Commission released a consultation paper on the ***technical details of a possible EU framework for bank recovery and resolution***. The new framework aims to ensure that authorities have the powers and tools to resolve financial institutions in crisis, without taxpayers bearing the burden. The ultimate goal is to ensure that banks can be resolved in a way that does not threaten financial stability, minimises the risks of contagion and ensures the continuity of essential financial services.

In July, the Financial Stability Board published a ***consultation document on effective resolution of systemically important financial institutions***. The document consists of five main parts: resolution powers and tools, cross-border arrangements, planning for resolution, removing obstacles to resolvability and discussion notes (creditor hierarchy, depositor preference and depositor protection in resolution, conditions for imposing temporary stays).

In 2011, some other regulatory proposals were raised to reduce the frequency of bank crises and isolate their impacts. These include restricting banks' own account trading and ownership acquisition (U.S.) and ring-fencing retail banking operations (services to households and SMEs - U.K.)



The EBF and the *IBFed*<sup>11</sup> support the creation of special resolution regimes for financial institutions, to protect society from the costs of failure and to limit the effects of contagion to the financial system as a whole.

### III. Financial supervision - European Banking Authority

In 2011, the Basel Committee on Banking Supervision and the Joint Forum<sup>12</sup> reviewed and updated their previous supervisory guidelines. Accordingly, consultative documents were published in December on *core principles for effective supervision* and on *principles for the supervision of financial conglomerates*.

In accordance with relevant decisions, *a new European supervisory architecture was introduced as of January 2011: the European Systemic Risk Council and the European System of Financial Supervisors* were set up and **the European Banking Authority (EBA), the European Securities and Markets Authority (ESMA) and the European Insurance and Occupational Pensions Authority (EIOPA), together: The European Supervisory Authorities (ESAs)** created through the transformation of the respective former committees.

In addition to its previously mentioned activities, operations of the European Banking Authority in 2011 included the issue of guidelines on corporate governance (GL 44), a proposal for an additional liquidity monitoring tool and a follow-up review of banks' transparency in their 2010 pillar 3 reports. The EBA also issued four new consultation papers, including guidelines on remuneration data collection (CP 46, CP 47), guidelines on the stressed VaR<sup>13</sup> (CP48), guidelines to the Incremental Default and Migration Risk Charge (CP49) and draft Implementing Technical Standards (ITS) on supervisory reporting requirements for institutions.

Following the adoption of CRR and CRD4, the EBA will have to develop a number of technical standards. In this, the EBA counts upon the cooperation of the national authorities.

### IV. Other regulatory developments

Other regulatory developments in 2011 included the Financial Stability Board's consultation on shadow banking. In addition to its previously mentioned activities, the Basel Committee conducted a *consultation on banks' internal audit function*.

EU-level regulatory efforts included proposed amendments to the EU Directives on Investor Compensation and Deposit Guarantee Schemes (the guarantee levels, the minimum funding requirements of the schemes, payout dates, etc.). However, failing agreement, the proposed amendments were not adopted.

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<sup>11</sup>IBFed: International Banking Federation (Founding members of the IBFed include the American Bankers Association, the Australian Bankers Association, the Canadian Bankers Association, the European Banking Federation and the Japanese Bankers Association. Associate members of the IBFed include the China Banking Association, the Indian Bankers Association, the Korea Federation of Banks, the Association of Russian Banks and the Banking Association of South Africa).

<sup>12</sup> The Joint Forum is a joint committee of the Basel Committee on Banking Supervision (BSBC), the International Organization of Securities Commissions (IOSCO) and the International Association of Insurance Supervisors (IAIS)

<sup>13</sup> Value at Risk