HUNGARIAN BANKING ASSOCIATION

REPORT

on 2013 Activities of the Hungarian Banking Association

Budapest, March 2014

Contents

1. Executive summary

As a positive change in the external economic environment, global economic growth sped up in the second half of 2013. The U.S. economy is back on a growth path and the euro-zone started to pick up after a year and a half of recession. The U.S. debt-ceiling debate was solved, there were no changes in the European Central Bank's interest rate policy and asset purchase programme and, despite earlier announcements, the FED did not reduce its asset purchases as of the end of 2013.

As a result of the low budget deficit and continuous current account surplus, Hungary's vulnerability decreased significantly. Good economic equilibrium indicators were coupled with better than expected growth figures. With a 1.8% growth in Q3 and a surprising 2.7% growth in Q4, Hungary's GDP grew by 1.2% on an annual basis in 2013. Inflation fell to an all-time low of 1.7%, although core inflation is still above the 3% targeted by the central bank. The MNB continued its rate cutting cycle during the year. (As of the end of December, the central bank base rate was 3%. By February 2014 it was reduced to 2.7%). Despite good economic indicators in the short-term, Hungary's growth potential falls behind that of the region and our lag continues to grow in the medium-term. The potential collapse of the HUF exchange rate, currently stabilising around HUF 300 against the euro, and any further excessive exchange rate cuts are a risk also in the short-term.

The banking sector continues to be characterised by a duality. The sector's capitalisation is strong, the loan-to-deposit ratio is improving, liquidity at the sector level is good, profitability is low. Although the sector's aggregate profit was a positive HUF 68 billion in accounting terms, looking behind the numbers one can establish that the sector made a loss again in the 2013 (HUF 118 billion in our estimate). In terms of profitability, the sector is split in two: there are some banks that despite the difficult conditions are still profitable, while a number of major banks have made tens of billions of forints of loss for years now. The stock of retail loans declined throughout the year, falling by 5.5% over year-end 2012. Despite a growth in Q3 attributable to the Funding for Growth Scheme, the stock of corporate loans dropped by 3.3% in 2013. The portfolio quality slightly deteriorated, the ratio of non-performing loans was 23.4% at year-end. The continuing low profitability, the low creditworthy loan demand and the regulatory stress hinders banks in fulfilling their role of stimulating real economic growth.

However, there were also some favourable government measures in certain lending segments. The introduction of the Funding for Growth Scheme and the launch of the second stage of the Scheme (with an allocation of HUF 500 million, which may be increased by the Monetary Council up to 2,000 million) have contributed to the slowing of the decrease in the stock of corporate loans and to the increase in the proportion of SME loans (57%). The comprehensive municipal debt consolidation, carried out in three steps, has provided security for banks, but at the same time, has spoiled the long-term business prospects in this segment. In retail lending, the multiple extensions and subsequently, the abolition, of the application deadline, and the relaxation of the eligibility criteria slowed the deterioration of the portfolio and thus, has been beneficial for the banks as well as for the customers.

Another positive fact for the economy and the banking sector is that the prompt conversion of FX loans into HUF was not imposed. As a major development, the Supreme Court – despite overheated expectations – adopted a sober legal uniformity decision, strengthening legal certainty. Also importantly, the Constitutional Court published its ruling in the middle of March 2014. The ruling made it clear that the Constitutional Court has no jurisdiction to examine the individual contracts. It also stated that for the state to amend the contents of a contract, the same conditions must be present as those required for a judicial amendment of the contract, and the legitimate interests of both parties should be taken into account.

It follows from the Constitutional Court's ruling that in relation to the contracts and the case law, the Supreme Court's December ruling continues to be governing.

At the same time, consumer-oriented provisions of the new Act on Credit Institutions, including the extension of the definition of home loans, provide better conditions for a wide range of retail customers.

In prudential regulation, the EU Capital Requirements Directive (CRR), taking effect in January 2014, and the new Act on Credit Institutions , transposing the EU Capital Requirements Directive (CRD IV) into Hungarian law will together constitute the prudential framework from now on. The joint application of the CRR and the Act on Credit Institutions will be a major challenge for the sector. The transition is also made difficult by the entry into force of the new Civil Code on March 15, 2014. The implementation of the new Civil Code will involve a learning process for banks' legal staff and the adjustment of operations to the new requirements. Another major change is the implementation of the Act on collateral register. Other areas, such as payments, will also require operational changes.

Banks and customers were adversely affected by the raise of the Financial Transaction Levy from August 1, 2013. The one-off extra contribution imposed on banks due to the shortfall in revenues from the FTL (208% of the levy paid on transactions executed between January and April 2013) caused banks an additional loss of HUF 75 billion. In payments, the raise of the Financial Transaction Levy, the imposition of the monthly two free cash withdrawals option and the regulation of interbank interchange fees are causing banks further losses and revenue shortfalls. The POS terminal deployment project, initiated by the MNB and financed by MasterCard to promote bank card acceptance imposed substantial tasks on participating banks, while the results fell short of the MNB's expectations.

The imposition of a healthcare contribution of 6% on interest income earned after August 1, 2013 in addition to the 16% personal income tax also puts bank at a competitive disadvantage versus government securities and hinders the improvement of the loan-to-deposit ratio.

In organisational terms, there were two important changes affecting the sector in 2013: the reregulation of the co-operative sector and the merger of the Hungarian Financial Supervisory Authority (PSZÁF) into the central bank (MNB). The creation of the mandatory integration of co-operative credit institutions and the nationalisation of Takarékbank, with the stated objective of efficiency improvement, prejudices shareholder interests. The merger of the supervisory authority into the central bank effective October 1, 2013 was implemented smoothly.

In 2013, the global and European regulatory bodies continued the drafting and finalisation of regulations aimed at eliminating the deficiencies arisen in the wake of the 2007-2008 financial crisis. Since the deepening and drawn-out recession is a serious political issue, developments in financial regulation are reviewed from time to time at the top political forums, including the G20 and European summits. In its progress reports to the G20 finance ministers and central bank governors, the FSB addressed the implementation of the Basel III capital and liquidity framework, aimed at strengthening the resilience of the banking system, the reform of resolution regimes to end too big to fail, the introduction of measures related to OTC derivatives, the regulation and monitoring of shadow banking activities and reforms to make financial markets safer. Activities of the Basel Committee on Banking Supervision were focused on the adoption of the final guidances on the Liquidity Coverage Ratio and liquidity monitoring tools and the revision of the capital requirements for the trading book and the securitisation framework. The development of the details of the regulation on ***leverage ratio*** is also a significant step towards completing the regulatory reform. The above issues and the finalisation of the Net Stable Funding Ratio will continue to be high on the Basel Committee's agenda in 2014.

In EU legislation, the adoption of the capital requirements and liquidity framework (CRR/CRD IV), the coming to an agreement on the Bank Recovery and Resolution Directive (BRRD) and the Deposit Guarantee Scheme Directive (DGSD) and steps related to the banking union (developing the organisational framework for the Single Supervisory Mechanism, and the proposal on a Single Resolution Mechanism are the main milestones. The development of detail rules for the Single European Rulebook and the drafting and application of its Implementation Technical Standards impose great burdens on the European Banking Authority and on banks, not to mention the European Central Bank's comprehensive assessment commencing in February 2014 and the subsequent stress tests. This tight schedule required and will require increased lobbying by the European Banking Federation and its member associations.

2. Macroeconomic outlook, operating environment

Following a slowdown at the beginning of the year, **global economic recovery** sped up in the second half of 2013. The second half of the year saw an improving business mood, with the U.S. economy growing again and the euro-zone picking up after a year and a half of recession. All this means that technically, the decline stopped. Due to the subdued economic activity and the decrease in energy and food prices, the inflationary pressure decreased in the global economy. The inflation rate in the U.S. and in the euro-zone was 1% as of the end of 2013.

There were no major shocks in the international money markets and no change in the European Central Bank's exchange rate policy and asset purchase programme. The U.S. debt-ceiling debate was solved. Although the FED had sent signals to the market since May about its plan to reduce its asset purchase programme, the actual cutback only began in 2014 and is spread out over time and carried out in several steps.

Hungary's vulnerability decreased significantly in 2013. The government is committed to keeping the budget deficit low. With the improved external equilibrium, the country's external debt fell. As a result, the economy grew (with one-off items playing an important role in this growth). However, the rapid improvement in economic equilibrium might entail growth sacrifices in the medium-term. The economy continues to be double-faced, with strong exports on the one side and a weak industry producing for a domestic market lacking funding and demand.

The Hungarian economy saw a surprising growth in the second half of the year. It grew by 1.8 and 2.7 percent in Q3 and Q4, respectively, year on year, resulting in a **GDP** growth of 1.2% on an annual basis. These good macroeconomic data were primarily attributable to the good performance of the agricultural sector and the car industry. The construction industry, starting from a low base, also improved significantly. Consumption also grew, with increasing exports, a moderate rise in domestic demand and a 7% rise in investments, the latter seeing an actual growth for the first time in five years.

Due to one-time effects (primarily, the government's utility cost cutting measures), **inflation** dropped to all-time low by the end of the year, falling to 0.4% in December year on year and 1.7% on an annual average basis. Core inflation net of one-time effects (for example, energy and unprocessed food prices) improved, too, although it is still above the 3% medium-term target envisaged by the MNB.

The **current account** balance, showing a surplus since 2009, exceeded 2% of GDP in the first three quarters of the year. As a result of government measures (in particular, the public work programme), the **unemployment rate** fell from 10.7% in 2012 to 9.1% in 2013.

Good inflation data and the relatively stable HUF exchange rate encouraged the MNB to continue its 25 and then 20 base-point rate-cutting cycle, reducing the base rate to below 3% by the end of the year. (With subsequent rate cuts, the base rate is now 2.7%). In the wake of the decreasing base rate, the HUF interbank benchmark rates and banks' HUF deposit and lending rates decreased further.

The **banking sector** continued to be characterised by a duality. Banks' capitalisation is strong, with a capital adequacy ratio above 17%. Liquidity at the sector level is good, although with large differences at the individual banks' level. The stock of loans continues to exceed that of deposits, with a loan-to-deposit ratio of 107%. The banking system is able to meet the account and cash turnover needs, that is, it is capable of fulfilling its fundamental short-term economic functions. At the same time, the continuing low profitability, partly due to government measures, the low creditworthy loan demand and the regulatory stress hinders banks in fulfilling their role of stimulating real economic growth.

Deleveraging continued. In addition to the reduction of forex assets, the flow of loans into more liquid assets continued, as well. The stock of **corporate loans** (both HUF and foreign currency) kept falling in the first half of the year. The stock of HUF loans saw a one-time rise in Q3, as a result of the MNB's Funding for Growth Scheme, then fell in Q4, nevertheless, rising on an annual basis by 8.4%. The volume of foreign currency loans decreased significantly, by 13%. The total stock of corporate loans fell by 3.3%. The share of SME loans in total corporate loans rose substantially, from 43% to 57%. The stock of **retail loans** declined throughout the year, falling by 5.5% over year-end 2012.

The proportion of **past due loans** was 23.2% in 2012 and 23.4% in 2013, in other words, the deterioration of the portfolio quality, although at a slower pace, continued in 2013. In retail mortgage loans, as a negative process, while the stock of past due loans remained relatively constant (33%-34% of the portfolio), the share of over 90 days past due loans rose compared to those under 90 days (16% vs. 17.1% as of December 2012, 19% vs. 14.3% as of December 2013).

The stock of **deposits** grew slightly, by 1.4%. However, there were some negative changes in the structure of deposits. The growth in the stock of deposits mainly came from a significant increase in **corporate deposits** (14.3%), almost exclusively attributable to the increase in current account deposits. **Retail deposits** continued to erode (-9.8%), a negative process, mainly attributable to the low interest rate environment the crowding out effect of government debt financing, creating an unlevel playing field, and the competition posed by investment funds. Other changes included the volatile increase in current account deposits and the significant drop in term deposits, which, due to the crowding-out effect of government debt financing (further interest rate cuts) might lead to further adverse changes.
As a result of all the above, the net **loan-to-deposit ratio** of the sector fell by 10 percentage points from the 117% in 2012 to 107% in 2013.

Interbank funds fell in 2013. **Domestic interbank funds** grew, primarily due to long-term loans taken from the central bank. The withdrawal of **foreign funding** continued in 2013. The decrease in foreign funds was mainly due to a significant reduction in **funds** (loans and deposits) made available by foreign financial institutions (mostly parent banks) to Hungarian banks. The stock of interest-bearing **securities issued by banks** dropped at a similar rate, somewhat offset by the issue of foreign currency bonds abroad by state-owned specialised credit institutions in the autumn.

According to preliminary, unaudited, **profit** figures, the sector was profitable in accounting terms, with an after-tax profit of HUF 68 billion. Excluding the profits of government institutions performing special functions (MFB, EXIM, KELER), the profits of Hungarian banks' foreign subsidiaries and measures taken by individual banks to increase their regulatory capital, affecting extraordinary profit items, the sector made a loss of HUF 118 billion in 2013. This negative result is primarily due to the special taxes (HUF 126 billion), the Financial Transaction Levy (HUF 215 billion, only partly included in banks' pricing), other burdens imposed on banks, and the increase in provisions due to the deterioration of the portfolio quality (HUF 302 billion). Despite the extra operating and IT costs entailed by an increasingly complicated regulation, the sector continued to cut costs, reducing them to the 2007 level. However, this could not offset the deterioration in profitability caused by the above negative effects.

3. Corporate lending

According to MNB statistics, the decline in the stock of corporate loans slowed in 2013. The stock of corporate loans fell by HUF 301 billion in the fourth quarter. Net of exchange rate effects, the decrease of corporate loans on an annual basis was 1.2% as of the end of 2013 (thanks to an increase in the third quarter). This is less than the 3%-4% annual drop rate seen in the past years. The volume of new loans under the Funding for Growth Scheme was moderate as of the end of 2013. It is expected to grow from the second quarter of 2014.

The reason for the decrease in corporate lending is the weak economic outlook, the low appetite for investment and the low level of foreign direct investment, and difficulties faced by certain sectors (the real estate sector, municipalities). All this reduces banks' lending appetite, whereas the interest of banks and companies would be to have more capital placements. Adding to this is the drop in risk tolerance seen since the beginning of the crisis.
As a positive development, the MNB's rate-cutting cycle is increasingly reflected in the pricing of corporate loans: the average interest rate on loans with a minimum maturity of five years fell to 4.94% by January 2014. The interest rates for Euro-denominated loans remained unchanged and so did the premiums. Another positive development is that the ratio of non-performing corporate loans decreased from 17.3% in Q3 to 16.4% at the end of the year.

3.1. MNB Funding for Growth Scheme

On June 1, 2013, the MNB launched its Funding for Growth Scheme to stimulate SME lending. Under the scheme, the MNB granted refinancing loans with zero percent interest and a maximum maturity of ten years. The total facility was HUF 750 billion, the application period was from June 1 to August 31. Financing banks could relend the central bank funds at a capped interest margin (a maximum 2.5% for guaranteed loans and a maximum 2% for non-guaranteed loans).

The first pillar of the scheme was aimed to reduce the financing costs of businesses with existing loans and to facilitate the implementation of investment projects hindered by high financing costs. The second pillar of the scheme was aimed to reduce foreign currency-based loans in the SME loan portfolio. Under the third pillar of the scheme, the MNB introduced FX swap and currency interest rate swap (CIRS) tenders with eight different maturities to add new euro liquidity.

According to MNB statistics, banks concluded loan contracts for 93.5% of the total scheme allocation, which means 10,000 contracts to a total value of HUF 701 billion. In view of the high demand under Pillar I, in August the MNB opened up the allocation of Pillar II for use in Pillar I. As a result, the take-up was close HUF 472 billion under Pillar I (112% of the allocation) and HUF 229 billion under Pillar II (70%). The scheme was used in all sectors, the agricultural, manufacturing and trade sectors had a particularly high share in the take-up.

With the success of Stage I of the Scheme, on September 11, 2013 the Monetary Council decided to continue the programme. The allocation for Stage II is HUF 500 billion, which may be increased by the Monetary Council up to HUF 2,000 billion. In Stage II, the MNB continues to make available refinancing with zero percent interest. Stage II of the Scheme was introduced on October 1, 2013 and will last until end-2014. 90% of the total scheme allocation is for new loans under Pillar I, 10% is for replacement loans under Pillar II. As opposed to Stage I, allocations under Stage II are awarded on a first-come-first-served basis. The combined upper limit, separately applied to HUF loans and loans replacing FX loans has been raised from the former HUF 3 billion to HUF 10 billion.

3.2. Cooperation with credit guarantee institutions

An important objective of the Association in 2013 was to promote corporate and SME lending through a stronger involvement of guarantee institutions. The Association's Credit Guarantee Working Group held several meetings with guarantee institutions to review the available guarantee schemes and the possibilities to change these schemes.

According to our information, these consultations also contributed to the fact that following the capital increase carried out by Hungarian Development Bank (MFB) in mid-2013, **Garantiqa Creditguarantee reduced its guarantee fees** for SME loans backed by government guarantees. Based on a government decision, a guarantee fee subsidy is available to SMEs for the entire loan period for loans granted after mid-2013. The subsidy is a maximum 0.75% of the full loan amount. If Garantiqa Creditguaratee provides a guarantee for 80% of the principal, then the annual guarantee fee payable by an SME may not exceed 0.5% of the full loan amount. (Previously, the average fee level was above 1.8%). Pursuant to the fees in force since the end of 2013, the annual guarantee fee payable by an SME may not exceed 0.3% of the full loan amount (0.5% for working capital and special working capital loans).

The approval time for guarantee applications has been reduced from 2014: applications accepted by Garantiqa Creditguarantee are appraised within 7 working days instead of the previous 15.

3.3. Municipal lending – debt consolidation of municipalities with more than 5,000 inhabitants

The government recast the laws regulating the day-to-day operations of municipalities and the provisions required for the performance of their tasks. In addition, the framework for their financing was also changed. As a major step, the government sought to consolidate those debts required by municipalities to ensure their day-to-day operations and the implementation of development projects previously not funded by the state.

To achieve this, the state provided a one-time non-refundable aid to county municipalities (HUF 197.6 billion) in 2011 and then to municipalities with less than 5,000 inhabitants and the multi-purpose micro-regional associations of these municipalities in 2012, as a repayment support for their debts to financial institutions (HUF 74 billion).

In continuation of the programme, under Act CCIV of 2012, the government fully assumed the debts to financial institutions of municipalities with more than 5,000 inhabitants, outstanding as of December 31, 2012, in relation to in-patient care and certain social care and child protection institutions, and partly assumed their other their debts to financial institutions outstanding as of December 31, 2012. (The rates of debt assumption by municipality were determined based on the ratio of the municipality's local business tax revenues per capita to the adjusted average local business tax revenue in the municipality's category as of June 30, 2012.).

The actual debt assumption rates (percentages) were agreed by the minister responsible for public finance and the minister responsible for municipalities on February 28, 2013. Agreements on prepayments and the assumption of debts under the actual contracts were concluded with each municipality and its creditors by the Minister responsible for public finances through the Government Debt Management Agency (ÁKK) by June 28, 2013 to a total value of HUF 630 billion.

In conclusion of the programme, under Act CCXXX of 2013 on the 2014 Central Budget, the government assumed municipalities' and their micro-regional associations' debts to financial institutions outstanding as of December 31, 2013.

The consolidation extends to the full debt (capital, delinquent capital) outstanding as at December 31, 2013 and the related charges (interest, late interest, commitment fee, handling fee) as at February 24, 2018. Pursuant to the 2014 Budget Act, the state may carry out the assumption of certain debt elements by granting a one-time support for minor debts not exceeding HUF 200 million, or CHF 815,000, or EUR 660,000. In this way, the technique for the assumption of minor loan debts can be simplified.

In the case of municipalities where bankruptcy procedures are in process as of December 31, 2013, the debts will be consolidated within 60 days from the closure of the bankruptcy procedure, under a separate process.

The Association was actively involved in the review of legislation related to the debt consolidation process, providing proposals to improve the legislation. In developing the main principles, which were also supported by the various associations of municipalities, we focused on the assumption by the state of foreign currency exposures. Banks, by making special efforts, duly met their statutory data provision obligation in all phases of the debt consolidation process.

4. Retail lending

According to the MNB's February 2014 report on Trends in Lending: "Loans outstanding continued to decline in the household segment, as repayments of loans exceeded disbursements by nearly HUF 114 billion in Q4. Households were net loan repayers in the case of both forint and foreign currency loans. The HUF 110 billion volume of new loans is somewhat below the value of contracts concluded in the previous quarter, but exceeds the value for the same period of the previous year by 30 per cent. The easing cycle observed in the past one and a half years continued in respect of conditions on unsecured consumer loans, while banks reported unchanged conditions for housing loans. In parallel with the decline in the reference rate, the annual percentage rate of charge (APR) on actual transactions fell to 8.8 per cent and to 11 per cent in the case of housing loans and home equity loans, respectively. The 5.5 percentage point interest rate spread on housing loans is still considered high in a regional comparison". The interest rate spread also reflects the high rate of non-performing and 90-day past due loans. As a result of this negative trend seen throughout 2013, the stock of retail loans in HUF fell by 5.5% over end-2012.

4.1. Developments regarding retail FX loans

Exchange Rate Cap Scheme – extension of the application deadline for the 2012 improved/extended Scheme to the first half of 2013; publicity campaign to promote the Scheme

The Exchange Rate Cap Scheme offers a general and comprehensive solution for the affected debtors that is supported by the government, the regulatory and supervisory authorities and banks. However, despite several extensions of the application deadline, the initial take-up of the scheme was rather low and slow. Hence, in February 2013, the Ministry for National Economy, the MNB and the Association launched an intense media campaign to publicise the scheme. The one-month campaign (repeated once more afterwards), involving substantial mass communication costs, was co-financed by the three parties and the Association assumed the task of organising and managing it. After the campaign was concluded, the government decided to abolish the deadline for applications for the scheme and allow debtors to join the scheme at any time. However, in the summer, applications were set back by debtors awaiting a new rescue package. (In these months, there were negotiations going on between the government and banks on how to address the situation of FX debtors). The take-up started to pick up again in December, partly due to the fact that on November 5, the Parliament significantly extended the scope of those eligible for the scheme. (Eligibility was extended to those in arrears for 180 days, those with a loan exceeding HUF 20 million and those benefiting from payment alleviation schemes. In addition, the relevant Act also incentivises banks to forgive a part of the debt by providing that a joint and several government guarantee is only available if the debt does not exceed 95% of the value of the property at the time of conclusion of the loan contract). According to MNB data as of the end of December, the number of contracts concluded under Exchange Rate Cap Scheme I and II was 173,144, representing 32% of those eligible. As of the end of December, participants in the scheme were relieved of HUF 26.3 billion in interest. The interest difference is shared on a fifty-fifty basis by the banking sector and the state.

As a further measure to increase take-up, banks were required to, by March 20, 2014, draw the attention of all those debtors, who, although eligible, had yet not availed themselves of the scheme, to the availability of the scheme. Also, to increase awareness of the scheme, from 2014 banks are required to inform participants in the scheme on the relieved part of debt (the part assumed by the bank and the state) for the current period and in total.

Programme to help debtors in arrears for more than 90 days

In May 2013, the government requested a proposal from the Association to resolve the situation of debtors in arrears for more than 90 days. The Association set up a working group from senior specialists from member banks. The working group proposed that the affected debtor groups should be categorised and then addressed accordingly:

- Debtors whose ability to pay cannot be restored anymore should be removed from the portfolio as simply and as soon as possible. To achieve this, proposals were made to simplify the handover of cases to the National Asset Management Company and to simplify the rules for foreclosures. The working group also proposed that to accelerate bilateral closure of the cases, banks be granted a state subsidy to mitigate their losses from the forgiveness of a part of the principal.
- For debtors whose ability to pay can be restored, the Working Group proposed forgiving a part of the principal, thereby reducing the monthly repayment amount. This preference, to be granted by the bank and the state, would have been conditional upon the debtor proving his ability and willingness to pay for an initial period (3 to 6 months).
- An important element of the proposal was that the willingness of debtors participating in payment alleviation schemes (restructured loans) to pay should also be strengthened.

In relation to dealing with delinquent debtors, the Association proposed the comprehensive review of the Act on Judicial Foreclosures. At the same time, we made a number of proposals to improve the efficiency of bailiffs' operations without the need to comprehensively amend the legislation. We initiated that the Decree on bailiff fees be amended to clearly specify the costs to be paid by the party requesting the foreclosure at the start of the foreclosure proceeding and that these costs should be reasonable and capped by law.

The Association's extended Board Meeting, attended by CEOs of the affected banks, reviewed and adopted the proposals made by the working group. However, negotiations with the government failed to lead to the expected results.

Development and submission of an FX debtor rescue package to the Ministry for National Economy

In September, the government gave banks an ultimatum to develop and present solutions for amending foreign currency-denominated loan contracts in a manner favourable for the customers. Without any specific statutory obligation, there are no legal grounds for amending the contracts, which, in addition, might have also breached prudential rules. Based on the initiative of the Association's appointed high-level expert group, the Board decided to meet the government's expectations by rethinking its previous proposals, by also taking into account those civil society proposals that meet the criteria set by the government. The revised proposal package was submitted to the Ministry for National Economy in late October.

To make use of the experience of and proposals made by debtors and civil society organisation, in the autumn we established an online consultation page on our web-site. More than 300 comments were received during the consultation period. Then, in October, we invited the most well-known of these organisations for a consultation. Seven organisations accepted our invitation. Those civil society proposals meeting the criteria set by the government were taken into account in the proposal package submitted to the government.

For home loans, the package proposed making the Exchange Rate Scheme mandatory for a wider range of customers, in accordance with the extended definition provided by the new Act on Credit Institutions, with an opt-out possibility, for CHF and EUR-denominated loans (making up the bulk of fx loans). In relation to litigations, we proposed that in case of a potential annulment of the loan contract, the court should provide for a settlement obligation in the same proceeding. Proposals included bringing forward the starting date of the winter eviction moratorium and the relinquishing of foreclosures for minor debts.

During the development of the proposals, the high-level working group also examined the possibility of converting the FX residential mortgage loans into HUF and the related consequences. Also, we consulted with external consultants and auditors on the treatment of such conversions under the IFRS. The consultants and auditors both said that in case of a prompt conversion of the loans into HUF at spot rates, the cash-flow deficit over the full loan tenor, arising from the difference between original loan product and the post-conversion loan product should be accounted for in one amount as a loss. The implementation of the proposals presented to the government would have caused a significant loss for the banking sector, although less than what a prompt conversion of the loans into HUF would have caused.

Finally, the government recommended debtors to join the Exchange Rate Cap Scheme, whose eligibility and other conditions was significantly relaxed. In addition, a number of measures were adopted to protect performing debtors: the definition for home loans was extended to allow as many debtors as possible to use the Scheme, and the law now provides that the mid-rate should be applied to all retail mortgage loan types in respect of disbursement, repayments (including early repayments) and fee calculations. Another customer protection measure is that the customer now has the right to apply for extension of the loan period free of charge.

Association working group on litigations related to FX loan contracts

In response to the increased number of litigations against banks, at the beginning of 2013 the Association set up a working group to assess and process experience related to these litigations. We compiled a document with answers to those questions which are raised the most frequently during litigations and by organisations acting on behalf of the debtors. The document provides answers to specific questions and references to precedence-setting court decisions, including the arguments made in these decisions. Based on this document, we also prepared a short summary document of the most important arguments.

In accordance with the Board's decision of July 1, 2013, we requested data from member banks (on an informal basis and mindful of the relevant privacy rules) on ongoing litigations related to FX loan contracts. As of mid-2013, there were some 2,000 litigations in process, some aimed at establishing the voidness of the loan contract and some aimed at stopping the foreclosure procedure. In most of these cases, there has either been no court decision, or there has only been a first instance court decision – and that, in most cases in favour of the banks. However, it can be seen that decisions in favour of the customer are receiving much more media attention than those in favour of the banks, which might present a false picture regarding the outcome of these litigations.

Supreme Court legal uniformity decision and Constitutional Court motion on FX loans

Since the autumn of 2013, political communications have increasingly called for a legal solution to the serious social problem of FX debtors, naming the Supreme Court's and the Constitutional Court's potential decisions as a starting point for a solution. On November 25, the head of the **Supreme Court's Civil Department** published his **motion for a legal uniformity procedure**, putting seven questions addressing the matters of principle raised in the related case laws regarding the validity of foreign currency-denominated consumer credit contracts and consumer leasing contracts. The Association's FX litigations working group analysed the questions and compiled a report on the issue.
On December 16, the Supreme Court published the gist of its legal uniformity decision, followed by the publication of the detailed reasons on December 23. The Supreme Court adopted a legal uniformity decision in most of the questions raised, in line with the current legal framework and with the vast majority of the decisions previously adopted by courts. Of the questions raised, the Supreme Court did not address the question of the fairness of unilateral contract amendments, in view of the ongoing case before the European Court of Justice. A decision in the case may be adopted by the ECJ at a later stage.

In its motion of November 28, the **government asked the Constitutional Court to interpret the Fundamental Law in two questions**. First: "*whether or not it can be derived from Paragraph (2) of Article M) of the Fundamental Law that a contractual provision applied en masse in a manner causing consumers a unilateral and material disadvantage, in particular, by assigning the exchange rate risk solely to the customer and giving the creditor a relatively free and wide discretion to raise the interest rates, and the contractual provision on the application of a spread and the relevant court decision confirming it, and the statutory provision serving as a ground for such provision and court decision are contrary to the Fundamental Law*. Second: the government asked the Constitutional Court to interpret "*Article II and Paragraph (1) of Article B) of the Fundamental Law in terms of under what constitutional conditions other than those provided by the Constitution may existing contracts be amended by law*."
The Association's litigations working group discussed the government's motion and developed a common position.

After several weeks of discussion, the Constitutional Court published its ruling in the middle of March 2014. The ruling did not create any new situation with regard to the loan contracts. The ruling made it clear that the Constitutional Court has no jurisdiction to examine the individual contracts. It also stated that if a material change in the circumstances so warrants, the contracts can be amended by law. For the state to amend the contents of a contract, the same conditions must be present as those required for a judicial amendment of the contract. In amending the contract by law, the legitimate interests of both parties should be taken into account and a balance of interests under the changed circumstances should be sought. It follows from the Constitutional Court's ruling that in relation to the contracts and the case law, the Supreme Court's December ruling continues to be governing.

4.2. Other developments

EU Mortgage Credit Directive (MCD) adopted

The competent EU forums adopted the Directive on mortgage credits at the end of 2013. The Directive took effect in January 2014 and member states will have two years to implement it.

The Directive is explicitly consumer protection-oriented and aimed to help the borrower in both the decision-making phase as well as during the contractual period. It regulates banks' tasks in virtually all phases of the lending process (such as providing mandatory contents for advertisements, requiring the provision of customers with a product comparison table) with a view to enabling the customer to make an informed decision. The Directive aims to provide the customer with continued support also after conclusion of the loan contract (such as the right to rescind the contract or the right to change currencies in the case of foreign currency loans).

Throughout the long drafting process of the Directive, industry associations (including the Hungarian Banking Association) have sought to ensure that consumer-protection aspects do not supress the aspects of implementability and banks' equitable interests. Largely thanks the European Banking Federation's efforts, the industry has managed to ensure that:

- the legislation does not relieve the consumer from the responsibility for the decision (there will be no requirement for banks to provide advisory services, the bank will not have to in the "best interest" of the customer),
- the bank will not have to automatically reject the applicant in case of a negative creditworthiness assessment. It will have the space to consider other aspects, while on the other hand, it will not be required to lend even if the creditworthiness assessment is positive.

The industry's efforts to reduce the scope of information to be provided to the customer to a reasonable level (for example, in advertisements) were less successful.

A major advantage of the Directive is that it is aligned in both spirit and structure with the Consumer Credit Directive (CCD), adopted a few years ago.

Further development of the Central Credit Bureau – data accuracy

The operator of the Central Credit Bureau, BISZ Zrt., has introduced new data accuracy principles and a new fee system to support data accuracy from January 1, 2014. This strategic change was agreed in details with the Association's Working Group on Central Credit Bureau.

The 2011 change in the legislation with the introduction of a "positive debtor list" was a major challenge for the organisation managing the Central Credit Bureau, with the volume of data to be processed trebling compared to the previous years. Data accuracy is key to the proper operation of the system. To achieve this, a new method was introduced:

The data to be entered into the system are categorised by importance and each category is assigned a different permissible error rate. (For example, important data determining the customer's creditworthiness must meet an accuracy rate of 99%, less important data must meet an accuracy rate of 95%). The manager of the Central Credit Bureau, BISZ Zrt. is using different tools to achieve the set accuracy rates. These include:

- sending notices to the reference data reporting entity,
- introducing a new data processing fee policy,
- using input filters to ensure the accuracy of incoming data.

BISZ emphasised that its objective was not to generate incremental revenues, but to incentivise high-quality reporting. BISZ hopes to achieve the set accuracy rates within two or three years.

Credit appraisal information from the Tax Authority

Specialists from member banks have indicated at several forums the problems encountered regarding the contents of tax certificates and their verification. A consultation between the Tax Authority, the Association and specialists from the bank initiating the meeting was held in the second half of June.

At the meeting, we reviewed the solutions currently in place with a view to ensuring that the tax certificates provided to banks contain the information needed. The means for verifying the certificates were also discussed. Also, it was agreed that the Tax Authority would standardise the contents of the certificates to be issued by its regional units. As agreed, the Tax Authority modified its IT systems from July.

5. Other important regulatory developments affecting banks

5.1. New Act on Credit Institutions, financial omnibus legislation

Parliament passed the new Act on Credit Institutions in December. In terms of contents, the new Act is basically the same as the former one. However, due to the several amendments it had undergone in the past 20 years and the ensuing fragmented structure, it was timely to re-edit the legislation. A new element in the new Act is the implementation of CRD IV: the prudential rules and corporate governance rules have been tightened, reliance on credit rating agencies has been narrowed and new capital buffers have been introduced. The consumer protection provisions of the Act have been modified and become more favourable for the customers.

From 2014, the operational framework for credit institutions will be determined by the new Act on Credit Institutions and EU Regulation 575/2013 on prudential requirements for credit institutions and investment firms.

In the context of the new Act on Credit Institutions it should be noted that a separate Act has been enacted on non-bank payment service providers and voucher issuers. We followed closely the drafting of this legislation, since these institutions carry out activities partly similar to those performed by banks, without a banking licence. Therefore, sector-neutral regulation is a fundamental requirement.

The implementation of the CRD, adopted together with the CRR, made it necessary to amend the Act on Investment Services as well as other acts. The relevant omnibus legislation also contains legislative amendments related the new supervisory functions of the MNB.

5.2. Legislation on the integration of co-operative credit institutions

In the middle of 2013, Parliament enacted a legislation on the reregulation of co-operative credit institutions and the creation of a mandatory integration of co-operative credit institutions. The law has put co-operative credit institutions under the control of Takarékbank as a central bank and established the Integration Organisation of Co-Operative Credit Institutions to be responsible for the prudential oversight and institution protection of co-operative credit institutions and their provision with the required regulatory capital. For the latter, a state fund of HUF 135 billion has been created (Cooperative Credit Institutions' Integration Fund). Also to ensure prudent operations, a Joint Capital Fund has been set up (now being filled up) as a joint and several guarantee of member cooperative credit institutions. Under the new legislation, the state (through the MFB and the Hungarian Post Office) has acquired a majority stake in Takarékbank (under a separate Act, this stake will be sold in the first half of 2014). Takarékbank and the Integration Organisation of Co-Operative Credit Institutions has a decisive control over the previously independent savings cooperatives, basically reducing them to branches. This legislation has significantly prejudiced savings co-operatives in respect of their former majority ownership in Takarékbank.

According to interest-representation organisations of co-operative credit institutions, the legislation violates certain provisions of the Fundamental Law. The key stakeholders were left out of the drafting of the legislation and government communications presented a much more negative picture of the credit co-operative sector (protected by an institution-protection fund) than the reality. The counter-arguments and objections and reservations of stakeholders were represented by the National Association of Entrepreneurs and Employers (VOSZ), whose membership includes several savings co-operatives.

The creation of the integration has hurt interests, but the legitimacy of the purpose, namely, to institutionally ensure the long-term prudent operation and the required regulatory capital of co-operative credit institutions with a view to financial stability is indisputable. This is also a primary interest of the banking community: the National Deposit Insurance Fund (OBA) had to pay out compensations to depositors in five instances in the past twelve years, in all five cases the defaulting institutions were co-operative credit institutions. 85% of these compensations have reduced the fund, contributed to by banks. Since the new legislation does not rule out the obligation for OBA to compensate depositors if a savings co-operative is excluded from the integration, we submitted to the government a proposal for an appropriate amendment to the legislation.

5.3. Developments related to the entry into force of the new Civil Code

Preparing for implementation of the new Civil Code

Preparing for implementation of the new Civil Code taking effect on March 15, 2014 is a key task for banks. This includes a learning process for their legal staff and adjusting operations to the new legal requirements. (Revising the bank's general terms and conditions, business rules, internal procedures, forms, customer information documents, etc.).

To promote the process, the Association organised seminars to present the main parts of the new Civil Code affecting banking. Seminars were held on the chapters on legal entities, companies and securities (the latter in collaboration with the Association of Securities Dealers).

In addition, we followed and commented on proposed amendments to the following laws related to the Civil Code:

- Act CLXXVII of 2013 on transitional and authorising provisions related to the entry into force of Act V of 2013 on the Civil Code,
- Act CLXXVI of 2013 on the transformation, merger and demerger of legal entities
- Act CCXXXVI of 2013 amending certain financial acts

Act CCLII of 2013 amending certain acts in relation to the entry into force of the new Civil Code, and a number of Government and Ministry Decrees related to foreclosure.

Prohibition of fiduciary collaterals – Act on fiduciary collateral register

The new Civil Code contains important changes with respect to collaterals. The new Code practically describes ("models") all contractual collaterals of a security interest nature through the legal institution of lien and prohibits a number of collaterals that have been used until now. Lien, if established on unregistered items (for example, real estates are registered in the Land Register), must be registered in a collateral register. Data related to sales with retention of title and factoring and leasing contracts also have to be registered.

Act CCXXI of 2013 provides detailed rules for the operation of the register. The Association was involved in the drafting of the legislation. In our comments we drew attention that the system will not be able to fully take over the role of fiduciary collaterals, since it will not be possible to establish whether the specific assets, rights and receivables in the register are free of encumbrance, since the lien will be registered in the system not by asset or right but by lienor/lienee. The system is expected to impose significant financial and procedural burdens on users.

The law was passed with minor amendments on December 9, 2013 and took effect on March 15, 2014. A serious concern is that the relevant implementation decree was only issued right before entry into force of the legislation. The system will only become operable with a substantial delay, which will hinder banks', leasing and factoring companies in their operations, since most of the former collaterals used are now null and void (and cannot be used in new contracts), while new collaterals cannot be applied in the absence of registration.

Act XV of 2014 on fiduciary asset management

The new Civil Law introduces the institution of fiduciary into Hungarian law. A fiduciary undertakes to manage the assets, rights and receivables entrusted to him by the principal under a fiduciary asset management contract. The Civil Code specifies the common law framework for this new legal institution, while the related public law regulations (such as licensing) are set out in a separate Act on fiduciaries and the rules for fiduciary activities.

We provided comments on the draft legislation on two occasions to the Ministry of Administration and Justice. We objected to the fact that financial institutions are excluded from fiduciary activities (the law provides that fiduciary activities can only be performed as a sole activity). In addition, we provided amendment proposals to the related laws and proposals for the detailed operational rules.

5.4. Other proposals for regulatory amendments

In addition to the above, we provided comments and proposals for regulatory amendments/measures regarding a number of other issues, including the following:

- We submitted a detailed report to the Ombudsman for Fundamental Rights on experience of the implementation of the Act on Judicial Foreclosure. (In addition to presenting the issues, we made proposals for amendments to the Act. Also, we proposed the introduction of a free choice of bailiff and customer-friendly procedures and the general reduction of bailiff fees).
- In relation to the proposed amendment to the Justice Ministry Decree on bailiff fees, we proposed that the fees for procedures related to the National Asset Management Company scheme should be reduced.

- We submitted proposals for amendments to the Bankruptcy Act in relation to the bankruptcy and liquidation proceedings for strategically important companies.
- In the same subject, we turned to the Minister in connection with MP motion No. T/10507.
- We reviewed and provided comments on the proposed revision to EU Regulation 1346/2000/EC on cross-border insolvency proceedings.

6. Development related to the Central Bank (MNB) and the Hungarian Financial Supervisory Authority (PSZÁF)

6.1. Merger of the Hungarian Financial Supervisory Authority into the Central Bank

The fifth amendment to the Fundamental Law has assigned the supervision of the financial intermediary system to the MNB. Accordingly, the new MNB Act has also assigned this function to the central bank. The new legislation has dissolved PSZÁF effective October 1, and the change in the organisation exercising the supervisory function has been updated to the legal system by a separate law, called the MNB omnibus legislation. We gave special attention to this legislation, given that, by definition, the change in the supervisory authority directly affects banks. Pursuant to the new bylaws of the central bank, a newly appointed MNB deputy governor is responsible for financial supervision and consumer protection. The change did not affect the former recommendations issued by PSZÁF and in terms of contents, the provisions contained in the existing PSZÁF decrees remained in force. However, it could be a source of problems in the future, given that the MNB, with its increased functions and powers, is not a legal successor of PSZÁF.

6.2. Conclusion of the MNB proposal related to bank's SWAP exposures

In July 2012, the MNB proposed that banks should voluntarily regulate their FX swap exposure limits. During the relevant consultations, the banking community was divided on the issue, so, despite multiple amendments, the sample declaration drafted by the MNB for signature by the banks was not adopted. At its meeting of February 12, 2013, the MNB Monetary Council decided to withdraw the proposal. At the same time, the MNB reiterated that it continues to consider the sector's aggregate FX swap exposure as high and will continue to monitor it and if necessary, use the regulatory instruments available to it.

6.3. Consultation on liquidity regulation

In the context of the new Act on Central Bank, assigning the role of financial supervisor to the MNB, member banks' treasury and market risk specialists held a meeting in September to discuss current issues related to liquidity. Following this consultation, in early October we wrote a letter to the MNB Deputy Governor responsible for monetary policy, requesting the MNB's position regarding the application of liquidity rules of the CRR and the recognition as central bank eligible collaterals of state debt or state-guaranteed debt to banks, in particular, former central bank eligible municipal bonds involved in the municipal debt consolidation. We also requested the MNB's support for the recognition of these instruments as liquid assets under the CRR.
In his response, the Deputy Governor informed that CRR implementation issues are addressed at the MNB by a newly set up Liquidity Working Group. The working group held its first meeting in early December.

In relation to the issues raises in our letter, we organised a consultation between the central bank and banks in late November. Representatives from the central bank said they did not find banks' proposals regarding collaterals warranted and the MNB did not wish to extend the scope of central bank eligible collaterals to securities. In relation to the implementation of the CRR, they said that, based on the information they had, they did not see any systemic concern. According to them, compliance with liquidity rules was a major concern and the MNB does not have any tools to help banks meet them. They also said that, to ensure smooth implementation, the MNB was looking forward to receiving information from banks regarding any issue that may arise. We collected banks' comments in two rounds regarding the interpretation of the various provisions of the CRR and sent them to the MNB Liquidity Working Group.

The working group sent us its position regarding the interpretation issues raised by banks concerning the various provisions of the CRR in the second half of February 2014. The working group pointed out that the final regulation making the general requirements more specific is to be adopted by the European Commission by June 30, 2014, therefore, national-level requirements can only be specified after that date.

6.4. BUBOR reform

In line with similar activities at the EBA and national supervisors, PSZÁF and the MNB have been actively working on reforming the BUBOR rate-setting process since the autumn of 2012. The Supervisory Authority conducted targeted inspections at 17 affected banks on the issue. Analysing the relevant data for the period between 2004 and 2014, the Authority established that although there have been some shortcomings in the rate-setting process, there are no signs of any manipulation. In the middle of February, the Supervisory Authority published for consultation a draft recommendation for the BUBOR rate-setting process. In our comments on the proposal we pointed out that the rate-setting process should be addressed as part of a wider reform of the BUBOR process. We proposed a consultation for the parties involved to clarify those issued not addressed by the recommendation and requested that the final recommendation only be issued afterwards. In their quadrilateral consultations, PSZÁF, the MNB, the Hungarian Banking Association and the Hungarian Forex Association addressed the contents of the recommendation and self-regulatory issues related to the BUBOR rate-setting process. Special emphasis was given to the development of the organisation of the sponsor of the rate-setting process (currently the Hungarian Forex Association's Technical Committee) and the further development of BUBOR as a product. In its recommendation issued on April 29, PSZÁF supported the strengthening of the organisation of the responsible committee of the current sponsor (Hungarian Forex Association) and the introduction of a mandatory contracting requirement in the future.

The Hungarian Forex Association circulated the draft agreement for cooperation in the redesign of the rate-setting process in July, followed by a modified draft in September. As a new element, this included the redesign of other rate-setting processes managed by the Hungarian Forex Association (BIRS, HUFONIA SWAP Index). The organisational and financing frameworks were set out in the draft agreement in accordance with our proposals. Review of the proposal is still in process.

In line with the PSZÁF recommendation, the Hungarian Forex Association in December announced the reduction of the number of BUBOR maturities from 14 to 8 effective February 2014.

6.5. PSZÁF recommendation on debt collection procedures

The Supervisory Authority drafted a recommendation on consumer protection requirements for banks in debt collection procedures. The recommendation is aimed to promote cooperative and fair attitude between banks and delinquent debtors. The recommendation only applies to retail debts. Debt collection is defined as an activity aimed to enforce a delinquent claim arising from the

provision of financial services on a commercial basis. The recommendation formulates general principles for debt collection: the principle of cooperative and fair attitude, the principle of due care, the principle of information provision, the principle of taking into account the debtor's financial capacity and the principles of gradualness and regulation. Furthermore, the recommendation provides best practices for debtor information and liaison. It provides sample information materials to be used in case of payment difficulties and pre-termination debtor information.
We conducted extensive consultations on the draft recommendation with banks' debt collection officers, as well as with financial firms and the Association of Hungarian Debt Collectors (MAKISZ). We gave comments on the proposed recommendation in several rounds. We proposed that the scope of the recommendation should be clearly defined. We also proposed that the recommendation should allow for a differentiated treatment between cooperative and non-cooperative debtors and the application of the principle of rationality in customer information. We provided specific proposals regarding customer information and contacting, liaising, and settlements with the debtors.

6.6. Supervisory reporting requirements

In 2013, we reviewed and commented on several occasions on the various proposed reporting requirements of the MNB and PSZÁF (the monetary statistical reporting package, the reporting requirements related to capital market and investment services, master data reporting, extraordinary data requests). Also, we conducted several consultations on the structure and contents of the separate auditor’s report to be filed annually with the supervisory authority.

However, the focal issue in reporting was preparing for changes in the prudential regulatory framework and the related reporting requirements under the CRR/CRD IV, taking effect in 2014. Preparations were hindered by the fact that the EU legislative process was not concluded by the end of the year. The European Banking Authority (EBA) submitted to the European Commission the relevant Implementing Technical Standards at the end of July. However, they were not adopted by the end of the year. Under the new COREP template package, Hungarian banks will have to file their first quarterly reports for the period ending March 31, 2014. Around 13 bank groups will be required to file FINREP reports, the first reports will be due on the period ending September 30, 2014. Banks listed on the stock exchange will have to compile their reports according to the IFRS. The decision on whether systemically important banks should prepare their reports according to the IFRS or according to the Hungarian Accounting Standards (HAS) will rest with the competent supervisory authority. Here, a problem is that decisions assigned to the competent national authority were not made by the end of the year, probably due to the MNB-PSZÁF merger in October. The Association launched a consultation process for member banks’ specialists to clarify issues arising during preparations for the new reporting requirements.
The Association indicated to the MNB that it was expecting a rationalisation of the reporting requirements in the wake of the merger of PSZÁF into the MNB, in particular, through the elimination of redundant data requests.
A review of the reporting requirements has commenced at the MNB, the benefits of this review may be first felt in 2015.

7. Payments

7.1. Changes in the legislation on the Financial Transaction Levy and their impact on modern payment methods

The Financial Transaction Levy (FTL), introduced as of January 21, 2013, has put Hungarian service providers in a competitive disadvantage. (Among other things, it is just this negative impact why a similar burden has not been introduced in Europe. There is no agreement at the global level, either, on the introduction of a Tobin tax, consequently, banks in jurisdictions applying a Tobin tax are put at a competitive disadvantage). It should be noted that as for its substance, the Hungarian FTL essentially differs from a Tobin tax, since a Tobin tax is aimed at taxing hot money).
Customers responded to the FTL rationally: those with multiple bank accounts have closed their redundant accounts with other banks and a number of large corporate customers moved their high-volume treasury operations abroad (primarily those denominated in foreign currency). Due to the shortfall in revenues from the FTL, the government increased the Financial Transaction Levy rates. Effective August 1, 2013, the general levy rate was increased from 0.2% to 0.3%, with the cap of HUF 6,000 remaining. At the same time, the levy rate for cash withdrawals and currency exchange was doubled (from 0.3% to 0.6%) and the former HUF 6,000 cap removed. In addition, a requirement was imposed on all financial services providers to pay a one-off extra contribution of 208% of the levy paid on transactions executed between January and April 2013. This was required due to the shortfall in revenues from the FTL, which was mainly due to the fact that the impacts of the FTL on payments had not been taken into account. The Association's Board expressed it strong protest against the imposition of an additional tax burden on the banking sector.

Particularly detrimental is the FTL on bank cards, which, together with the monthly two free cash withdrawals option, introduced in February 2014 as a consumer right, have entailed the negative consequence of a part of bank account payments retransforming into cash payments. Since cash is the most expensive payment method, the ensuing damages appear at the greater societal level. (According to an MNB study, the social cost of cash payments was HUF 388 billion or 0.49% of GDP in 2009). Another negative impact is that the excessive use of cash payments is a hotbed of the underground economy, which is detrimental from a fiscal point of view.

The reduction of cash transactions is a public interest. It can only succeed if bank account money is not dispreferred by the legislators by taxing it, while making the much more expensive cash payment method free of charge by law. We voiced this position on all possible forums and channels, unfortunately without success thus far.
As for the FTL tax returns, we managed to ensure that the initial several-page detailed form was significantly reduced by the time the first tax returns were due. However, subsequent consultations with the Tax Authority indicate that this initial state will not hold for long and we should expect increasing reporting requirements. Controlling and planning revenues from the FTL is a challenge for the Tax Authority, therefore, the Authority will expect more data from taxpayers.
The proposed EU Financial Transaction Tax (FTT) will not be introduced in 2014. Accordingly - and contrary to the original text of the legislation - the Hungarian FTL will not be extended to investment services.

7.2. Legislation on the monthly two free cash withdrawals option, drafting of the Act on customer statements

In the context of the reduction of utility prices, the Parliament incorporated a new provision into the Act on Payment Services. Pursuant to this, cash withdrawals twice a month up to HUF 150,000 in total are now a consumer right. The consumer may exercise this right in respect of one bank account designated by him, which means that if he has several accounts, he has to choose. The customer must apply for the free cash withdrawal option by providing a statement. The text of the statement is provided by the relevant Economic Ministry Decree. Consumers could first exercise the free cash withdrawal right from February 1, 2014, subject to submitting the relevant statement, either in person or online, by January 20, 2014. The implementation of the legislation, adopted at the end of

2013, required extraordinary efforts from banks. The Association assisted banks by promptly asking for clarifications and amendments to the legislation. Banks duly met their statutory obligations by the set deadline.
Ever since the proposal for the free cash withdrawal option was issued, the Association has voiced its counter-arguments at all forum, including the relevant Parliamentary committees, stressing that

- the free cash withdrawal option contravenes the principles of a market economy, since it requires the service provider to provide a service involving costs free of charge,
- it will push consumers into the shadow economy, since it facilitates tax evasion, and
- it will set back financial innovation for decades.

To make sure that the customer has only designated one account for the free cash withdrawal option, a central register will be set up under a separate law, to store and manage the related customer statements. Although the law requires the central register to be put in place by the end of 2014, we managed to ensure that the relevant legislation was enacted in early 2014, thus allowing sufficient time for implementation. We also managed to ensure that the law assigns the management of the central register to BISZ Zrt., the manager of the Central Credit Bureau. The Association's working groups and BISZ's specialists were actively involved in the drafting of the legislation on the central register.

7.3. Other development related to card payments

Regulation of interbank interchange fees

On September 23, 2013, the Parliament passed the Act regulating the interchange fees for domestic transactions. This caps the interbank interchange fees for debit and credit cards at 0.2 and 0.3 percent, respectively. This regulation is unprecedented in Europe in terms of both extent and introduction date, since the European Commission's proposal, envisaging similar rates in the EU, provides for an implementation period of two years. Thus, the application of the reduced fees is being tested in a "live environment" in Hungary, opening up significant security and business risks in the Hungarian bank card market, which thus far has seen significant growth even by international comparison. Over the past year and a half, the Association has drawn attention at all forums to the potential risks of an inadequately drafted regulation.

POS deployment project

International research and an MNB study on the social costs of using cash have revealed that modernising payments and promoting the use of electronic channels may result in annual savings in excess of HUF 100 billion for the economy. In line with these objectives, the MNB initiated a project for the deployment of POS terminals to merchants, aimed to promote bank card payments. The programme was financed by Mastercard. The deployment of the POS terminals was carried out by six institutions providing card acceptance services (BB, Erste, K&H, OTP, Six Payment Services and Takarékbank). The project was supported by the Fejér Country Chamber of Commerce and Industry. Participants contributed with comprehensive organisational work and the allocation of resources for the project. The Association assisted in coordination as a member of the Project Steering Committee. Merchants and service providers in Fejér County can use the POS terminals at preferential terms for two years. The deployment of POS terminals started in September and the deadline for joining the project was December 31, 2013. A key objective of this pilot project is to obtain information on the main obstacles to the spread of card acceptance as well as on the opportunities, thus contributing to the modernisation of payment services.

The Association turned to the Prime Minister Viktor Orbán and leaders of the Ministry for National Economy in several letters in connection with current measures affecting payment services, including the raise of the Financial Transaction Levy and the caps on interchange fees, however, thus far without success. In our letters we pointed out the risks entailed by the regulations adopted by Parliament: the disproportionately high limit for free cash withdrawals and the retention of the FTL on card payments involve serious risks and adverse impacts.

7.4. Basic payment accounts, bank switching

Upon an EU initiative and a request from the Hungarian government, there are currently two Association self-regulations in place. Under the self-regulation on basic payment accounts, banks offer a bank account facility with a number of services and low costs to those customer who have no bank accounts yet. The self-regulation on bank switching is aimed to assist those customers who want to switch replace their current banking relationship with a new bank.
Based on data from member banks, in 2013

- 60,400 basic payment accounts were opened, including 1,600 by non-Hungarian EU citizens, considerably more than in 2012. (In 2012, there were 21,520 BPAs opened, of which 660 by non-Hungarian EU citizens.)
- Under the simplified bank account switching procedure, 4,300 costumers initiated switching, out of which 2,700 cases were successfully completed, roughly the same number as last year.

The new regulations and new burdens on banks (the raise of the FTL, the reduction of interchange fees, the introduction of the monthly two free cash withdrawals option) have changed the operating environment of banks. Accordingly, both self-regulations should be revised, by also taking account of the proposed EU Directive.

7.5. Involvement in the Electronic Payments and Clearing System (EFER) project

The EFER project is aimed to radically reduce the number of credit transfers made to wrong account numbers in payments to government agencies, by putting in place a home banking system. Citizens and companies will be able to pay their dues through their regular electronic payment solutions by initiating a single credit transfer transaction (even to several accounts at the same time). In view of the nature of the task, the Association proposed the involvement of GIRO in the project. However, after several consultations organised by the Association, the government agency responsible for the project chose another solution. At the same time, leaders of the project requested the Association to organise a consultation to present to members' heads of the areas affected (e-Channels, IT Development and Payments) the objectives and expected benefits of the project and the conditions for banks to join the system. The consultation was successful, with high attendance, and since then, several banks have joined the system.

7.6. Review of the Payment Services Directive (PSD2)

The Association's Payments Working Group reviewed the draft of the proposed revision of the PSD. Based on this review, we sent our comments to the European Banking Federation as follows:

- we proposed that due to their different natures, bank cards and other electronic payment instruments should be treated separately,
- in the case of bank cards, the limit on the cardholder's liability before notification of the incident (EUR 150) should be retained, while the setting of this limit for electronic payment

instruments (online payments, mobile banking) should be a national discretion, based the local circumstances,

- instead of the current unsettled legal situation, the Directive should set out the prudent behavioural standards expected of customers in relation to the secure handling of electronic payment instruments,
- we proposed that in case the new payment services to be introduced by the Directive (account information services, payment initiation services) are provided by a third party, the Directive should regulate the relationship between the bank managing the account, the customer and the third party providing these services in a clear-cut manner.

A number of our proposals were incorporated into the position represented by the EBF at the international forums.

7.7. Payment Accounts Directive (PAD)

At the request of the Ministry for National Economy, we commented several times on the proposed EU Directive. The Directive aims to promote the comparability of bank account fees and to help EU citizens in opening basic payment accounts and switching banks.
The Hungarian supervisory authority already has a system in place for the comparison of bank account fees as proposed in the Directive. However, the ex-post annual fee information requirement would impose extra tasks on service providers. We requested the Ministry to advocate at the EU forums for an information requirement that is much less extensive in terms of the amount of data to be provided and more transparent for the customer.
We proposed to reject facilitating bank switching at the EU level, since this intends to address an unlifelike situation and would require the development of a highly expensive and complicated system. Switching banks means that the customer decides to move his banking relationships (receiving salary, making utility payments) to another bank, to pay less fees. The regulation on bank switching is aimed to promote the moving of banking relationships between banks. When the customer moves abroad, he will have completely new banking/payment relationships (new employer, new utility providers).
In commenting on the proposed Payments Accounts Directive, we proposed that the Directive should allow as much national discretion as possible, since the tackling of social issues (including the issue of basic payment accounts) is a matter for the individual member states. During consultations at the EU level, the proposed Directive has been amended favourably for banks in several points.

8. Taxation, accounting

8.1. Taxation issues

In addition to the Financial Transaction Levy, we addressed several other taxation issues in 2013. We held regular consultations with specialists from member banks and the appointed special high-level working group conducted negotiations with the government on issues related to the various changes affecting banks' operations and products. We welcomed the fact that our year-long efforts for the **tax exemption of loan forgiveness** have been successful: effective 2014, loan forgiveness – under certain conditions – is tax-free, both for the creditor and the debtor.

A major achievement in relation to the issue of **VAT on bank card services** was that the Ministry for National Economy confirmed the industry's position that card scheme services are complex services

and are considered as financial services, and accordingly, under the harmonised EU VAT law, are exempt from VAT.
As a new restrictive measure in 2013, a healthcare contribution of 6% was imposed (with a few exceptions) on interest income earned after August 1, 2013, in addition to the 16% personal income tax. (Since the yields on government securities are not subject to this 6% healthcare contribution, the introduction of this burden increases the crowding-out effect of government securities on deposits and hinders the improvement of the loan-to-deposit ratio). We requested rulings regarding the related technical issues several times and emphasised that implementation would require comprehensive IT development works and the 30-day period remaining until the entry into force of the legislation was extremely short.

Prudential and tax law changes entailed the need to address the accounting rules for **general risk provisions.** According to the new rules, general risk provisions made in previous years could be transferred in part or in whole into retained earnings in one step on December 31, 2013, subject to a 19% tax. The Ministry for National Economy also accepted our proposal for amending the rules for the credit institution contribution on the transfer of provisions to retained earnings. With this amendment, the contribution will be of a company tax nature, clearer and more manageable: the transfer of provisions to retained earnings has become optional, and banks may choose to only transfer a part of the stock of provisions (as opposed to the former regulation, which required the transfer of the whole stock of provisions into retained earnings).

A major issue for banks is the **classification of SMEs**. Monitoring the customer's compliance with the SME status criteria on a continuous basis is unmanageable. In our view, the problem should be solved by changing the relevant tax regulations. During the summer, we initiated with the Tax Authority and the Ministry for National Economy that the Tax Authority should publish a list of businesses classified as SMEs, based on the classification to be indicated by businesses' in their tax returns. The are several SME financing programmes running and it would be helpful if an official SME list were made available from a common official database. Regrettably, our proposal was not supported, essentially because the data are not verified and there is no legal ground for such disclosure. Hence, we drafted a text proposal to require businesses to state their SME status in their tax returns. We also submitted a proposal to adjust the provision related to SMEs in the Bank Tax Act.

8.2. Accounting issues

In addition to the taxation rules, the treatment of **general risk provisions** entailed changes in the relevant accounting rules. Effective fiscal year 2014, banks may not increase their risk provisions, and existing risk provisions may only be reduced if used. The rules for the use of risk provisions are rather narrow, allowing provisions to only be used for losses not previously covered by impairment/provisions.

The Government Decree on **accounting rules for credit institutions** was amended in accordance with our proposal regarding the mandatory accounting order of repayments, by providing that repayments should only be accounted for according to the mandatory accounting order for repayments, if not otherwise provided. This provisions facilitates the application of the Civil Code provision allowing for a deviation from the mandatory accounting order, if such deviation is in favour of the debtor. During the review of the proposed regulation, we also requested some other regulatory amendments aimed at convergence to the IFRS. The Ministry responsible for drafting the legislation said it was open to discuss some of these proposals in 2014.

8.3. Ministry for National Economy programme for transition to the IFRS

At the beginning of the summer, the Ministry for National Economy launched a programme for transition to the IFRS reporting standards in Hungary. Shifting from Hungarian Accounting Standards to IFRS will, inter alia, require the following::

- education and training (there is a shortage of IFRS experts) ;
- the consequences of opting for IFRS or HAS should be tax neutral;
- consistency should be ensured in issues affecting other legal areas (e.g., company law);
- the scope of those entities for whom IFRS would be mandatory and those for whom it would be optional should be defined.

Undoubtedly, the financial sector's specifics and statutory obligations (compliance with prudential requirements, reporting obligations, monetary and statistical aspects, etc.) require special attention.

During the discussions, managed by the Ministry for National Economy and involving representatives from the auditing profession, listed companies and representatives from the financial sector and the accounting profession, we emphasised our position as follows:

- mandatory application at the solo level should only be imposed after due adjustments to the related regulations, and with an implementation period of at least two years,
- those ready should be allowed to opt for IFRS for fiscal year 2015,
- the content requirements for Notes to the Balance Sheet should be reduced for small banks,
- SMEs involved in the consolidation should be allowed to apply IFRS at the solo level on a voluntary basis,
- for other financial institutions equivalent to credit institutions (guarantee organisations), the use of IFRS should be optional.

The IFRS transition programme continues in 2014. The Association and several of its member banks are involved in it.

9. Bank security

9.1. FX debtor demonstrations

Following the Supreme Court's ruling, some groups presenting themselves as advocacy organisations for FX borrowers started to draw attention to themselves through rallies and actions involving the damaging of bank branches and intimidating bank employees. These incidents became regular from the second week of August, a fact largely contributed to by the perplexity of the police. By the autumn, the demonstrations were already directed at banks' CEOs and even the Prime Minister.
We called for the National Police Headquarters in several letters to take action, within the appropriate legal constraints, against these violent acts, causing banks damages, intimidating bank employees and disturbing public order.
From the end of August, increased cooperation was launched between banks' physical security heads and the Police to restrain the demonstrations and to investigate the motivations of the leaders and their mass base. It was established that these demonstrations are attended by a very small number of people (10 to 35), who, however, are aggressively drawing attention to themselves, in particular from the media. It was also revealed that the organisers of these demonstrations had previously acted as credit agents and had themselves borrowed large loans, providing real estates other than their homes as collaterals.

9.2. Cooperation with the National Police Headquarters

In the second half of the 2013 we worked together with the National Political Headquarters on several issues:

- The Police introduced a new emergency, operation control and deployment system effective December 8, 2013. The National Police Headquarters made available to banks dedicated direct telephone numbers to the operation control centres.
- We worked together on a proposal to amend the regulations on the disclosure of bank secrets in criminal investigations.
- In November, the National Police headquarters launched an internal review to identify any other issues that might arise in connection with data inquiries related to criminal investigation, with a view to improving the relevant procedures. The Police requested banks' input and proposals under the coordination of the Association. We provided the requested information to the Ministry. Work is being in process at the Ministry.

9.3. IT security

The organisational framework for coordinating and managing critical infrastructures and the IT security of central and local government institutions has changed from March and July 2013, respectively. The Association and banks had had close cooperation with the Theodore Puskás Public Foundation, the organisation operating CERT-Hungary before the enactment of the new legislation. Following the enactment of the new legislation, the tasks of the Foundation have been taken over by the Disaster Management Authority, in respect of critical infrastructure, and the Special Service for National Security, operating the Government Incident Response Team (GovCERT), in respect of central and local government institutions.
The development of cooperation with the new government IT security organisations to promote banks' IT security operations was a key objective in the Association's IT Security Working Group's 2013 work programme. To achieve this, the Working Group met in December with the Head of GovCERT to discuss the possible forms of cooperation.

10. Association developments

10.1. 2013 General Meeting – Awards

The Association's supreme decision-making body, the General Meeting adopted the report on 2012 activities of the Association, the 2012 financial report of the Association and the Association's budget for 2013. The General Meeting elected Dr Mihály Patai (UniCredit Bank) again as President for a term to last until the Association's 2014 elections. The General Meeting also elected György Zolnai, President & CEO, Budapest Bank and Éva Hegedűs, CEO, Gránit Bank (the latter representing small and medium-sized banks on the Board) as new board members, filling recent vacancies on the Board, for the same term. The General Meeting elected new arbitrators to the Permanent Court of Arbitration of Money and Capital Markets (the term of the former arbitrators expired on June 30, 2013).
The General Meeting adopted the Association's new Rules. The new rules provide that the Association considers the Association of Banks and Savings Banks, operating between 1919 and 1948 as its intellectual predecessor. Under its new Rules, the Association's newly defined objectives, in addition to advocacy, are to improve the quality of financial services, strengthen customer confidence and promote financial literacy. The new Rules have enabled the Association to represent

the widest possible range of players in the sector. The have also authorised the Association to influence the operations of certain organisations serving the banking sector, including by acquiring stakes or membership and nomination rights in these organisations.
The Association's Golden Beehive Award was presented for the second time in recognition of outstanding individual performance in promoting the banking sector's development and operations. The recipients in 2013 were:

- Dr István Ónody (OTP Bank)
- Dr Edina Parkánszki (ERSTE Bank)
- Zsuzsanna Péter Berecz (K&H Bank)
- Dr Zsolt Lajer (Commerzbank)

László Harmati (FHB), resigning from the Board in February and Péter Csicsáky, leaving as CEO of Takarékbank in early July, received the Golden Beehive Award. Batara Sianturi leaving as CEO of Citibank was awarded the Golden Beehive Commemorative Medal.
At the Association's Pre-Christmas Dinner, Sándor Csányi (OTP Bank) and György Surányi (CIB Bank received the Association's highest recognition, the Golden Beehive Decoration for their decades of work for the sector. The Association's retiring staff member, János Müller was granted the Golden Beehive Award for his years of work for the Association.

10.2. Association working groups

In addition to consultations conducted in writing, the Association develops the banking community's positions at meetings of its working groups and, in especially important issues, at meetings of its high-level working groups, made up of members of the Board. The Association's working groups worked actively in 2013. They held more than 150 meetings, attended by more than 3,000 colleagues. In terms of importance of the issues addressed, the activities of the working groups on retail FX loans and related legal issues, the working group addressing the new Civil Code the working group on payments and the working group on bank security should be highlighted. The intensity of law-making and other measures affecting banks is reflected in the fact that in addition to its regular meetings, the Board held several extraordinary meetings in 2013, in some cases extended to include the CEOs of the most affected members.
The Foreign Bankers' Club only held one event in 2013, with a member of the Monetary Council attending. At the Club's meeting held in January 2014, Ádám Farkas, Executive Director of the European Banking Authority gave a presentation.
Pursuant to a decision made in December 2013, the Association took over the tasks of the Hungarian SEPA Association. The Association's new SEPA Working Group will be responsible for cooperation with the European Payments Council (EPC), representation of the Hungarian banking industry in the EPC and the development and updating of the national SEPA strategy and national SEPA plan.
(See details in the Annex).
The consultative forum of small and medium-sized banks commenced operations at the beginning of 2014. At the first meeting of the forum, changes in the regulations on collaterals under the new Civil Code were presented.

10.3. Participation in the EBF's working committees

The European Banking Federation is the main source of information regarding global and economic developments affecting the financial world. Our associates were actively involved in operations of the various EBF working committees in 2013, including the Executive Committee and the EBF's technical committees and working groups. Based on the information obtained at the meetings and the various written documents received for information/review we are continuously following and informing members on the latest developments, including the various EU-level proposals affecting the banking sector, the drafting of regulations and directives and the related positions of the European Banking Federation. Through the EBF, we receive up-to-date information on regulatory work of the Basel Committee on Banking Supervision. The EBF is an important information exchange forum, offering the opportunity for members to inform each other on practices in their countries.

10.4. Cooperation with the banking associations of the Visegrád Group

In 2013, the Association actively participated in the consultations between the banking associations of the Visegrád Four countries (the Czech Republic, Hungary, Poland and Slovakia). The V4 countries have similar characteristics and share similar historical experiences, a fact that contributes to efficient joint work. The next semi-annual meeting of the V4 Group was held in November in Budapest. The extended meeting was attended by the Slovenian Banking Association. The meeting addressed current European and EBF-related issues, the banking sector's regulatory and taxation patterns, and development trends of the sector, in particular, the expansion of online banking services.

10.5. Visiting member banks in the provinces

Visits at member banks in the provinces help in obtaining information about their situation, their strategy and the roles they play in their respective regions and their views on the various issues. At the visits paid to Duna Takarékbank, South-Transdanubian Regional Bank, Sopron Bank and Kinizsi Bank, associates of the Association were received by top executives of the banks, who presented the main characteristics and specifics of their banks' operations. These visits provide a good opportunity for building personal relationships and providing members with first-hand information. Taking account of our non-Budapest members' comments, we put in place a conference call system in the fourth quarter of the year, a valuable asset helping our working groups' operations.

10.6. Association events, conferences

Conference on IFRS9

In March 2013, the Association and PwC Hungary organised a conference for banks on IFRS 9 Financial Instruments. It was in 2008 that the IASB and the FASB decided to reduce the complexity of the accounting standards for financial instruments and replace the current IAS 39 Financial Instruments: Recognition and Measurement standard with a new IFRS 9 standard. The development of the IFRS 9 standard commenced in three phases.
A presentation on the proposed changes was held at the conference by Yulia Feygina (practice fellow), an associate of the IASB, who is directly responsible for one of the projects. Additional topics included the proposed changes to the impairment methodology and their interrelation with Basel II as well as other important changes to the IFRS (hedge accounting, leasing). Presentations on these issues were held by internationally well-known experts from PwC. The technical day offered a good opportunity to review issues arising in banks' operations and provide an official feedback on the IASB proposal.

Tax Forum

In December, we held our regular Tax Forum on next year's tax law changes, in cooperation with Ernst&Young. The technical afternoon addressed tax laws directly affecting banks. Issues included the tax exemption of loan forgiveness, the accounting rules for the partial redemption of long-term savings deposits after three years and the scope and procedure for the transfer of information during the moving of a long-term savings deposit to a new service provider (facilitated from 2014).
The transferability of Long-Term Investment Accounts (TBSZ) was a major item of interest for banks' specialists. Accordingly, we launched a special consultation on the issue with the involvement of the Association of Securities Dealers. In relation to VAT, issues related to the billing of continuous services and the change in the rules for the self-revision of corporate tax returns were addressed. The need for a regulatory amendment in relation to the EUR 40 lump sum collection fee under the Civil Code and the related excessive administration requirements was also raised, since this burden is caused by a wrong transposition of the relevant provision of the EU Directive.

The Association's staff members actively participated in other forums and conferences. Our associates held presentations at the Management Forum's 2nd Financial Consumer Protection Conference and the International Banker Training Centre's training courses and chaired and held presentations at various financial events.

10.7. Communications

The Association had virtually continuous media appearances on issues affecting the banking community throughout 2013. The most frequent were our appearances in the online media, in 2,400 instances, followed by the print media, in 1,300 instances, and the electronic media (TV, radio), in 550 instances. In total, we had more than 4,250 appearances and mentions in the Hungarian media in 2013. Public and media attention was focused on the following:

- Issues related to FX lending, including the extended Exchange Rate Cap Scheme,
- The introduction of the Financial Transaction Levy and its increase in August, the related conditions, the impact of the FTL on the banking system and on customers,
- Tasks related to the monthly two free cash withdrawals option (the preparation and receipt of the related customer statements, customer information, the preparation of ATMs and the handling of the limits).

We informed representatives of the media on current issues at our traditional press meetings and in eight press releases.
Experience shows that our messages are conveyed in a fast and efficient way to the public through dialogue with financial and business journalists. The high number of media inquiries shows that the Association and its representatives continue to be regarded as key financial opinion-makers.
We continued to receive a lot of approaches from customers seeking assistance or advice or regarding the handling of their complaints. Most requests were related to the Exchange Rate Cap Scheme, many indicating repayment problems. All customer inquiries were answered. Individual cases were forwarded to the banks in question.

ANNEX - INTERNATIONAL DEVELOPMENTS

I. PRUDENTIAL REGULATION, SUPERVISION

In 2013, the global and European regulatory bodies continued the drafting and finalisation of regulations aimed at eliminating the deficiencies arisen in the wake of the 2007-2008 financial crisis. Since the deepening and drawn-out recession is a serious political issue, developments in financial regulation are reviewed from time to time at the top political forums, including the G20 and European summits. Below is an overview of the most important developments in financial regulation. We will review the various global and European initiatives and provide a brief summary of the European Banking Federation's operations and responses to the various regulatory proposals.[1]

Global regulation

financial reform programme. In its progress reports to the G20 finance ministers and central bank governors, the FSB addressed the implementation of the Basel III capital and liquidity framework, aimed at strengthening the resilience of the banking system, the reform of resolution regimes to end too big to fail, the introduction of measures related to OTC derivatives, the regulation and monitoring of shadow banking activities and reforms to make financial markets safer. In ending too big to fail, the FSB documents on identifying systemically important firms in different sectors, imposing higher capital requirements and more intensive supervision on these institutions (including more effective risk management), reforming national resolution regimes, a framework for the cross-border recognition of resolution actions¸ the FSB principles for an effective risk appetite framework and the FSB guidance on supervisory interaction with financial institutions on risk culture should be highlighted.

Remaining tasks include consistent and full implementation of the Basel III framework, the explanation and reduction of the worryingly large differences in the IRB risk models, the finalisation of the regulations on leverage and liquidity ratios, the enhancement of risk disclosure and the harmonisation of the treatment of non-performing loans. In 2014, the FSB will finalise policies to mitigate the systemic risks of the repo and securities lending market (a key funding source for shadow banks) and the Basel Committee will finalise proposals to address the risks from banks' interactions with shadow banks and adopt regulatory standards and capital requirements for bank exposures to central counterparties. Also, the FSB and the International Monetary Fund operate a joint project to eliminate data gaps and ensure information exchange and information sharing.

To ensure market safety, national authorities should introduce requirements for the reporting of all derivatives trades to trade repositories, adopt rules for central clearing and trading on organised platforms and adopt resolution regimes for financial market infrastructures such as central counterparties.

In 2013, the Financial Stability Board (FSB) and the Basel Committee on Banking Supervision (BCBS) focused on monitoring the adopted frameworks, including the Basel III capital and liquidity framework, the bank resolution framework and the regulation on OTC derivatives.

Activities and publications of the other main international regulatory body, the Basel Committee on Banking Supervision (BCBS) in 2013 were focused on the following:

[1] Detailed reports on regulatory developments are provided in the annexes to our quarterly reports.

(1) In relation to the regulatory reform programme adopted in the wake of the financial crisis, the Basel Committee continued to draft the remaining details of the Basel III framework. In early 2013, it adopted the final guidances on the ***Liquidity Coverage Ratio*** and ***liquidity monitoring tools***, amending the definitions for High Quality Liquid Assets (HQLA) and net cash outflow and the timeline for the introduction of the LCR.

The Basel Committee also published a proposed common template for LCR, to be completed and disclosed by internationally active banks. In addition, it revised the ***capital requirements for the trading book*** and the ***securitisation framework.*** The development of the details of the regulation on ***leverage ratio*** is also a significant step towards completing the regulatory reform. The above issues and the finalisation of the Net Stable Funding Ratio will continue to be high on the Basel Committee's agenda in 2014.

(2) The Basel Committee's ***Regulatory Consistency Assessment Programme*** (RCAP), adopted in 2012 consists of two distinct but complementary work streams to monitor the timely adoption of Basel III standards and to assess the consistency and completeness of the adopted standards, including the significance of any deviations in the regulatory framework. To ensure regulatory consistency, the Basel Committee assesses Basel III adoption by jurisdiction. In addition the Committee publishes semi-annual assessments on the implications of Basel III standards for banks.

(3) The Basel Committee gives special emphasis to transparency and clarity of the regulatory framework. In June 2012, it commissioned a task force to review the Basel capital framework to identify opportunities to remove undue complexity within the framework and improve the comparability of its outcomes. Based on this review the Committee issued its discussion paper entitled "***The regulatory framework: balancing risk sensitivity, simplicity and comparability".***

(4) Supervisory efficiency is one of the Basel Committee's key priorities. Accordingly, it issued its consultative document entitled "***Supervisory framework for measuring and controlling large exposures***", replacing the Committee's 1991 guidance. The proposal goes beyond credit risk and addresses the assumption of large exposures as a whole. It also makes proposals for the monitoring and regulation of shadow banking. Other related documents of the Committee include the guidelines on data aggregation, FX exposures and the revised guidelines on external auditors and on exposures related to money laundering and terrorist financing.

A major step in ***regulatory developments in the USA*** in 2013 was the adoption in December of the ***final rules to implement the Volcker Rule,*** providing for the separation of trading activities. These prohibit insured depository institutions and companies affiliated with insured depository institutions (banking entities) from engaging in short-term proprietary trading of certain securities, derivatives, commodity futures and options on these instruments, for their own account. They also impose limits on banking entities' investments in, and other relationships with, hedge funds or private equity funds.

Prudential regulation in the European Union

Capital and liquidity framework: CRR/CRD IV[2]

The trilogue[3] on the capital and liquidity framework was concluded in March, with a compromise text. As a key element of the framework, a flexibility package was agreed. Pursuant to this, national authorities may apply systemic risk buffers in three categories: buffers for global strategically important institutions, buffers for other systemically important financial institutions and systemic risk buffers. In addition to capital buffers, the regulation allows member states to impose macro-prudential measures to address systemic and macro-prudential risks, including in such sensitive areas as the level of own funds, the level of the capital conservation buffer and the risk weights for residential and commercial property. At the proposal of the Commission, to be agreed with the

[2] Capital Requirements Regulation and Directive

[3] Members of the trilogue are: the European Commission, the European Council and the European Parliament.

European Banking Authority (EBA) and the European Systemic Risk Board (ESRB), the Council may reject stricter national measures proposed by a member state. Favourable compromises for banks were reached in relation to the treatment of minority interests, SME lending and trade finance and Credit Value Adjustment (CVA), the application of prudential filters, the weighting of exposures to central governments and central banks denominated in the currency of a member state, and, in line with the Basel Committee document, liquidity requirements. A not fully satisfactory compromise was reached on the treatment of deferred tax assets. The retention of the Basel I floor and the provision allowing member states to raise the Loss Given Default (LGD) ceiling are unfavourable solutions. As for the remuneration of management, a key political issue, it was agreed that (with the exception of some qualified majority decisions) the fixed to variable remuneration ratio shall not exceed 1:1. From 2015, banks will be required to disclose, by country, their profits, taxes paid and subsidies received and sales and staff numbers. Following the legal and linguistic reviews (checking of the translations) of the text adopted on April 16, the European Parliament and the ECOFIN[4] readopted the capital and liquidity framework. The final CRR/CRD IV texts were published in the European Union's Official Journal on June 27, followed by their corrected versions in November. The capital and liquidity framework, this important piece of legislation fundamentally determining the operating conditions for European banks, took effect on January 1, 2014.

Bank Recovery and Resolution Directive (BRRD)

Another important objective in addition to regulatory measures to strengthen the resilience of the baking system in the wake of the 2008 financial crisis was to regulate financial institutions, and in particular, banks' risk management. Following the publication of the FSB's basic document, the European Commission published the draft of the Bank Recovery and Resolution Directive (BRRD) on June 6, 2012. In line with the scope of application of the CRR/CRDIV, the BRRD will apply to all credit institutions and investment firms, irrespective of size or activities.

The BRRD was subject to fierce debates in the European Parliament and the Council. This is reflected in the fact that instead of June 2013, a compromise on the contents of the Directive was only reached in December. The main differences were around the scope of bail-in instruments, the date of introduction of the bail-in requirement, the eligibility of deposits for bail-in, the appointment of a special manager, the joint management and target levels of resolution funds and deposit guarantee schemes, mandatory EBA mediation in the resolution colleges, home/host decisions, and state intervention (fiscal backstop). In December, a compromise was reached on the contents of the BRRD. The compromise enables the Directive to be adopted by the European Parliament and Council Directive on its first reading and to take effect in all member states on January 1, 2015.

The draft directive establishes a range of instruments to tackle potential bank crises at three stages: prevention, early intervention, and resolution. Banks will have to draw up recovery plans and update them annually, setting out the measures they would take to restore their financial position in the event of significant deterioration. Resolution authorities will have to prepare resolution plans for each bank. Authorities will also have the power to appoint "temporary administrators" or special managers to an institution if its financial situation were to deteriorate significantly or if there were serious violations of the law.

The bail-in provisions will enter into force on January 2016 (as opposed to the Commission's initial proposal of 2018). The directive requires member states, as a general rule, to set up ex-ante resolution funds. These national funds will have to reach, by 2025, a target level of at least 1% of covered deposits of all the credit institutions authorised in their country. The directive offers the possibility, under exceptional circumstances and subject to state aid rules, to temporarily inject capital into solvent banks that cannot access private funds. To ensure that banks always have sufficient bail-inable liabilities, the directive provides for national resolution authorities to set

[4] Economic and Financial Affairs Council: the council of EU finance ministers

minimum requirements for own funds and eligible liabilities (MREL[5]) for each institution, based on its size, risk and business model. A review in 2016 will enable the Commission, based on recommendations by the EBA, to introduce a harmonised MREL applicable to all banks.
In view of the close link between resolution funds and deposit guarantee schemes, the Deposit Guarantee Scheme Directive and the relevant provisions of the BRRD were discussed in parallel during the trilogue.

Deposit Guarantee Scheme Directive (DGSD)

The discussion on the Deposit Guarantee Schemes Directive (DGSD) was suspended after MEPs decided in February 2012 to have a second reading. It was only re-opened when the discussion of resolution funds under the BRRD began. Thereafter, the Deposit Guarantee Scheme Directive and the relevant provisions of the BRRD were discussed in parallel and the agreement on resolution funds entailed an agreement on Deposit Guarantee Schemes. Under this, the deadline for compensation payments made by GDSs will be gradually reduced from the current 20 working days to 7 working days. The new Directive will require better, and standardised, information to be provided to depositors. Deposit guarantee funds will have to be funded ex-ante. The minimum target level will be 0.8 % of covered deposits. The minimum target level must be met within 10 years. Under the system of risk-based contributions, banks with riskier business policies will have to pay higher contributions. The Directive will allow DGSs to borrow from each other.

European banking union

The plan to establish a European Banking Union (EBU) was published concurrently with the draft of the BRRD on June 6, 2012. The banking union would rest on four pillars: a Single Supervisory Mechanism (SSM), a Single Deposit Guarantee Scheme, a Single Resolution Mechanism (SRM) and a Single Rulebook. The announcement of the establishment of a banking union can be regarded as a response to the crisis, however, its implementation is slower than planned.

Single Supervisory Mechanism

Although the introduction of a Single Supervisory Mechanism (putting banks under ECB supervision) was delayed, it was the SSM where the greatest progress was made in 2013. Following adoption by the European Parliament on September 12, 2013, the European Council adopted the SSM framework on October 15, 2013. The new regulation on the ECB and the amendment to the regulation on the European Banking Authority (EBA) took effect five days and one day respectively after their publication in the EU Official Journal. The SSM will start operations one year after its publication in the Official Journal, in November 2014. The ECB's monetary and supervisory functions will be strictly separated to avoid potential conflicts of interest. A supervisory board responsible for the preparation of supervisory tasks was set up within the ECB. The board's draft decisions will be deemed adopted unless rejected by the ECB governing council. Pursuant to the Regulation, members of the SSM supervisory board include the chair, the vice-chair (chosen from members of the ECB Executive Board), four representatives of the ECB (Directors General of the ECB) and one representative of the national competent authority of each participating member state. Non-euro-zone countries participating in the SSM will have full and equal voting rights on the supervisory board. The EBA regulation was amended to ensure that the countries participating in the SSM do not unduly dominate the EBA's board of supervisors. The EBA will retain its competence for further developing the single rulebook. The ECB signed agreements with the European Parliament in November and with the Council in December. The purpose of these agreements, inter alia, is to work together in

[5] Minimum requirements for own funds and eligible liabilities

developing and setting up the SSM as soon as possible. Were necessary, the ECB shall conclude memoranda of understanding with the competent authorities of non-participating member states, describing in general terms how they will cooperate with one another in the performance of their supervisory tasks.
The ECB is conducting a comprehensive assessment on banks that will be subject to direct supervision by the ECB (128 in number). Elements of the assessment include a supervisory risk assessment (SRA), an asset quality review (AQR) and a stress test to be conducted in collaboration with the EBA.

Single Resolution Mechanism

The next step towards a banking union will be the establishment of a Single Resolution Mechanism. The European Commission's relevant proposal was published with some delay in early July. For legal reasons, the proposal assigns the function of a resolution authority to the Commission. However, the actual decisions will be made by a Single Resolution Board (SRB). The ECB, as the supervisor, would signal when a bank needed to be resolved, while the resolution will be prepared and the resolution plan developed by a Single Resolution Board. The Commission would decide whether and when to place a bank into resolution and would set out a framework for the use of resolution tools and the fund. Under the supervision of the Single Resolution Board, national resolution authorities would be in charge of the execution of the resolution plan.
There were fierce debates between member states over the Single Supervisory Mechanism. The debates were focused on the SRM decision-making mechanism and the Commission's role in it, the voting process of the Single Resolution Board (SRB) and the voting proportions, the scope of the SRM, the funding of the SRM (a single fund or cooperation between the national resolution funds), bringing forward the bail-in rules, and the question of where the SRM should be headquartered.
At the ECOFIN[6] meeting of December 18, member states agreed on the contents of the Single Resolution Mechanism. Member states requested the EU presidency to start negotiations with the European Parliament to adopt the SRM in the current parliamentary cycle (before the EP elections in May 2014). Members of the banking union committed to transforming their national resolution funds into a Single Fund (SRF) over a transitional period of 10 years. (National funds would contribute 10% of their funds in the first year, 20 percent in the second year, to reach 100 percent in the tenth year, and the SRF's share in the resolution costs would also grow accordingly). The ECOFIN ministers also agreed on a backstop for the SRF. The single resolution mechanism would cover all banks in the participating member states. The Single Resolution Board would be responsible for the planning and resolution phases of cross-border banks and those directly supervised by the ECB, while national resolution authorities would be responsible for all other banks. However, the board would always be responsible if the resolution of a bank requires access to the single resolution fund. Should a national authority not comply with a decision by the board, the board could address executive orders directly to the troubled bank.
There are still important differences regarding the speed of implementation of the single Resolution Fund and its decision-making process. If agreement is reached on these issues, the SRM would enter into force on January 1, 2015, thus, the period during which the Single Supervisory Mechanism operates without a Single Resolution Mechanism would be minimal.

The development of a Single Deposit Guarantee Scheme fell victim to political compromises, member states only committed to further harmonising their existing schemes.

Structural reform

[6] Economic and Financial Affairs Council: the Council of EU Finance ministers

Not being among the European Commission's priorities in 2013, there was little progress made regarding the proposed structural reform of the banking sector. The Liikanen Committee's September 2012 report proposed the separation of trading activities above a certain size/amount. In its own-initiative report, the European Parliament's Economic and Monetary Affairs Committee (ECON) supported the separation of risky trading activities. At the same time, following the U.K., some other member states, including Germany and France decided to adopt national regulations, thus jeopardising the single market. Finally, the European Commission issued its proposal for the separation of certain trading activities as late as January 2014. The Commission's proposal is much more permissive than the Liiknanen Committee's proposal. According to the Commission's proposal, the restrictions would apply to global systemically important banks that in three consecutive years exceed EUR 30 billion in total assets and EUR 70 billion in trading assets and liabilities. According to current data, 29 banks are affected. Banks covered by the Regulation would not be allowed to engage in proprietary trading and would be prohibited from owning, sponsoring, or having exposure to hedge funds. In case of exceeding certain thresholds, supervisors will have the power to require the separation of additional trading activities. Activities such as market making, investment and sponsorship of complex securitisation and the sale and trading of derivatives will be under the close watch of supervisors in terms of whether or not they pose a threat to the bank or to the stability of the financial system. (Sovereign debt trading will not be taken into account). The proposal provides supervisors wide discretion regarding separation. However, the fact that most of the banks affected by the reform will be subject to direct supervision by the ECB may ensure uniform treatment. Those member states, where similar separation rules are in place may be granted a derogation under a certificate from the European Commission.

Other regulatory developments

Other major regulatory developments in 2013 included the European Commission's report on the Financial Conglomerates Directive (FICOD), the Green Paper on long-term financing of the European economy, the revision to the regulation on credit rating agencies, the revision to state aid rules, effective August 1, 2013, and the Commission's regulatory proposals on shadow banking and money market funds.
The European Systemic Risk Board (ESRB) issued a set of recommendations on intermediate objectives and instruments of macro-prudential policy in April. More than two years after its publication of its recommendations on FOREX lending in September 2011, the ESRB assessed member states' compliance with the recommendations.

European Banking Authority

In its third year of operation, the EBA's activities - in line with its mission - continued to be focused on the Single Rulebook. The EBA prepared a number of implementing technical standards to the CRR/CRD IV. The adoption of these standards is delayed due to the delay in the capital and liquidity framework. In addition to standards, the EBA's consultations on liquidity and on the internal models approach and its interim report on the consistency risk weighted assets in the banking book are all aimed to ensure the consistency of regulation in Europe. The EBA's activities related to the Bank Recovery and Resolution Directive are also aimed at the Single Rulebook and the single market. Following the promulgation of the new capital framework, to ensure the stability of the European banking system the EBA issued a recommendation for the preservation of Core Tier 1 capital until full implementation of CRR/CRD framework (January 1, 2019). Also, the EBA regularly monitors Basel III implementation.

Risk assessment is a key priority in the EBA's operations. The EBA assesses risks and vulnerabilities in the European banking sector on a semi-annual basis and provides a risk map of European banks, while cross-sectoral risks are assessed by the Joint Committee of the European Supervisory

Authorities. In its supervisory activities, the EBA focuses on identifying, analysing and managing the main risks in the EU banking sector and monitoring banks' capitalisation and capital planning with a view to promoting compliance with the new standards.

Of the EBA's 2013 documents, especially important from a Hungarian point of view are the EBA opinion on good practices for responsible mortgage lending and the EBA opinion on good practices for the treatment of borrowers in mortgage payment difficulties
Under its consumer protection activities, the EBA prepares annual consumer trends reports. The EBA is highly committed to consumers and promotes the transparency, simplicity and fairness of banking products.

Another important development in 2013 was the EBA-ESMA joint action to strengthen Euribor and benchmark rate-setting processes..

European Banking Federation

The European Banking Federation continued active lobbying activities at both the global and European forums. A perceivable change compared to the previous years was that it expressed its views publicly more often on key issues.
The EBF advocated at all forums for regulation that ensures – also globally - a level playing field, and for a single European market. Upon adoption of the CRR/CRDIV, the EBF expressed its disappointment over the little progress made with regard to the Single European Rulebook. In relation to the BRRD, the EBF consistently pointed out the need for harmonised bail-in instruments and for a harmonised date for the introduction of the bail-in tool.
The EBF supported the introduction of a banking union, including a Single Resolution Mechanism. However, it emphasised that this should be conditional upon an operable Single Supervisory Mechanism, implemented in all BRRD member states, and a solution to deal with the legacy assets of the recent crisis.
The EBF made all efforts to ensure that the comprehensive assessment to be conducted before the introduction of the SSM is carried out in a transparent manner and its results can be properly interpreted by the profession and the public. In relation to structural reform, the EBF consistently represents the need to preserve the universal banking model, which has proven itself during the financial crisis. The EBF is of the view that the structural reform should await the implementation of the other regulatory measures.

II. SINGLE EURO PAYMENTS AREA, SEPA OUTLOOK 2014

The SEPA project will enter a new stage in 2014 in pan-European terms as well as domestically. Pursuant to the SEPA end-date regulation[7], the deadline for migration to the SEPA Credit Transfer and SEPA Direct Debit schemes is January 31, 2014 for the euro-zone and October 31, 2016 for the non-euro-zone member states. Based on the ECB's second SEPA migration report[8] and its survey on the SEPA payment schemes it is expected that not all euro-zone member states will be able to meet the deadline. This may entail regulatory intervention. Significant changes are expected in the management of the process, with a view to improving effectiveness and efficiency: a new body with

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[7] REGULATION (EU) No 260/2012 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 14 March 2012 establishing technical and business requirements for credit transfers and direct debits in euro and amending Regulation (EC) No 924/2009

a changed composition, the Euro Retail Payments Board (ERPB), replacing the SEPA Council will commence operations in 2014.
The European Payments Council will continue to be among those organisations representing the supply side on the ERPB. In view of these changes, the EPC is reorganising itself to give more emphasis to tasks related to the operation of the SEPA payment schemes versus those related to the development of the schemes.

In this changing pan-European environment, the framework for SEPA cooperation between banks and the management of related tasks also changed at the end of 2013. Pursuant to the agreement signed on December 16, 2013, the Banking Association has taken over the functions and tasks of the Hungarian SEPA Association from 2014. This means that the Hungarian Banking Association will step in in the place of the Hungarian SEPA Association on the international forums, including the representation of the Hungarian banking community in the EPC and its working groups. Also, in view of the organisational changes in the EPC and the continuously emerging new tasks, new working groups may be created (primarily for tasks related to the development of innovative payment solutions). In terms of structure, the Association's newly set up SEPA working group will follow the two-tier set-up well-proven in the Hungarian SEPA Association: decisions will be made by a Steering Committee made up of working group members, based on proposals to be presented by the standing or ad hoc working groups responsible for the subject in question.

Within this framework, at the start, the SEPA Payment Schemes, the Account Statements Working Groups and the National Adherence Support Organisation (NASO) will be created. The Association took several aspects into account when it decided to take over the ongoing and future tasks of the dissolving SEPA organisation: the broadening of its range of members, the ability to mobilise the whole banking systems through closer contacts with banks' top executives and the opportunity to involve other working groups of the Association in the process, all this with a view to ensuring that the remaining technical tasks on the supply side and the tasks related to the information of stakeholders to deepen their SEPA awareness on the demand side are successfully and efficiently implemented by the migration date of October 31, 2016.

[8] SECOND SEPA MIGRATION REPORT, October 2013, ECB