



HUNGARIAN BANKING ASSOCIATION

REPORT

Activities of the Hungarian Banking Association in 2016

Budapest, March 2017

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I. Executive Summary

In 2016 ***the world economy*** kept on growing, still at a low level but at a somewhat accelerating pace in the last quarter. According to the January IMF forecast, the annual GDP increase was 1.6% in the United States, 1.7% in the euro zone, 0.9% in Japan and 6.7% in China. The sustainable increase in oil prices supports economic recovery in Russia. During the year, several important political events took place (Brexit decision, the American presidential election, Italian referendum on constitutional reform), that influenced the global economy to a great extent, increased market uncertainty and endangered stability. The monetary policy pursued by the central banks of global importance changed in various directions: at the end of the year the Fed raised its base rate by 25 basis points and new interest rate raises are likely for 2017; while the European Central Bank prolonged its asset purchase programme, and the Japanese central bank did not change its existing schemes, facilitating additional asset purchases.

In 2016 the performance of the ***Hungarian economy*** fluctuated; the annual GDP growth rate slowed from 3.1% in the previous year to 2%. In 2016, the relatively modest growth rate compared to the preceding two years was, apart from the stagnation of industry, primarily attributable to the fact that investments related to EU assistance ramped up more slowly than expected. It was a surprise that external trade also held back the growth rate, but presumably only to a small extent. At the same time, employment increased by nearly 140,000 people; the lack of a qualified work force is appearing in an increasing number of sectors. Companies are forced to raise wages significantly to retain their workforce. In terms of balance indicators, the position of the budget remains extremely favourable. The annual budget deficit was only 2.4% of GDP; the government deficit decreased below 74 per cent of GDP, and the foreign exchange ratio within the government deficit fell to around 25 per cent. The country's external vulnerability improved significantly. Consumer prices increased by 0.4% on average; core inflation remained solidly below 2%. In the first half of the year, the central bank decreased the base rate from 1.35% to 0.9% in three steps and kept this level in the second half of the year. In order to channel the liquidity held with the central bank to money and capital markets (lending, government securities), National Bank of Hungary (MNB) significantly decreased the portfolio that can be kept in standing facilities.

During 2016, the aggregated balance sheet total of **credit institutions** increased by 4% in nominal terms and surpassed the HUF 34,000 billion level. The significant increase in foreign exchange stocks was associated with a minor decrease in forint stocks. On the liabilities side, deposits and equity increased while the portfolio of securities issued by banks decreased. This increasing deposit portfolio went hand in hand with the shortening of the average maturity. The deposits from non-financial undertakings grew to the greatest extent; the household deposit portfolio increased to a moderate extent only. Thanks to the considerable increase in the profit reserve and the profit for the year, the aggregated equity of credit institutions grew by 25%; the industry's capital adequacy ratio exceeds 20%. The main driver for the increase in the asset portfolio was the expansion of the loan portfolio and the restructuring towards sovereign bonds - supported by the MNB self-funding scheme. In nominal terms, the total gross loan portfolio increased by 9.2%, but its internal structure changed in a particular way; while exposure to financial institutions and foreign customers grew vigorously, the loan portfolio with non-financial corporations fell back to a small extent, and the one with households considerably. Recognised impairments decreased nearly by one-third in each customer segment. The *net loan-to-deposit ratio* of the credit institutions sector changed from 87% at the end of the previous year to 91%. In 2016, pre-tax profit was outstandingly good compared to previous years (HUF 535 billion); the average pre-tax return on assets (ROA) of the banking industry was +1.5%; and its return on equity (ROE) was +15.7%, resembling the indicators of the years preceding the crisis. However, these good profit indicators are typically explained by one-off factors, or factors independent from the operation of the Hungarian banking industry. Over the medium

term, the still large portfolio of non-performing loans and the environment of low returns have a negative impact on the profitability of the banking system in Hungary as well.

Last year, the **Funding for Growth Scheme (FGS)** of the National Bank of Hungary also greatly contributed to the mitigation of the decrease in corporate lending. Between 1 January and 31 December 2016, credit institutions participating in Stage 3 of the scheme concluded HUF 473 billion worth of contracts in relation to more than 17,000 transactions and more than 11,000 enterprises. Three-quarters of the contracts made in Stage 3 are new investments loans, and one-fourth are new lease transactions. (In stage 3 no working capital loans and loan consolidation were possible.) According to the MNB's newest lending report published in March 2017, the revision of the first year of Market-Based Lending Scheme has successfully closed, reaching a consolidated annual compliance of 150 percent. Only 2 of the 17 banks could not reach the expected target level.

The **Family Housing Allowance (CSOK)** was unable to stop the considerable reverse in household lending (6%), despite the new preferences the Government introduced into the rules of housing subsidies taking effect at the beginning of the year. (For example, for new homes the upper price cap for properties that can be purchased was cancelled, or the amount of free state subsidy grew further, etc.). Following lengthy inter-departmental negotiations, in September 2016 the decrees regulating the CSOK again eased. (In the last year, banks concluded approximately 23,000 CSOK contracts, under which HUF 66 billion worth of grants were disbursed, and lending related to these grants also greatly increased. The real pick-up of the scheme is expected to take place in the forthcoming years.) By the end of 2016, out of the loans for new homes 1/6 were disbursed under CSOK, which could be influenced by changes to the regulation.

With regard to the earlier disbursed loan portfolios, the **MNB Recommendation on the recovery of retail mortgage loans in default** put serious operational burdens on banks. Under this Recommendation, the lender has to complete an extremely complicated, time-consuming and costly procedure to restore the long-term solvency of the debtor before terminating a defaulted loan or, for already terminated loans, before selling that loan. Subject to their legal objections, the banks did not support the publication of this Recommendation in view of the earlier debt consolidation schemes, and the possible negative effect on still paying debtors (moral hazard), but they obviously implemented the measures set out in it. Data known so far appear to confirm the banks' concerns, as the results are not commensurate with their significant efforts.

The task to prepare for the application of the **domestic legislation transposing the Mortgage Credit Directive** as of 21 March 2016 also constituted a difficult task for the institutions concerned. The interpretation of *Act (CLXII of 2009) on Loans extended to consumers*, transposing the Directive, and the relevant amendments to the *Credit Institution Act*, as well as the related implementing decrees, raised numerous issues, and it even necessitated further legislative corrections to some points.

The final closure of the settlement procedure completed in 2015 was confirmed by, **Uniformity Decision No. 1/2016 PJE of the Curia**, stating that a foreign-exchange based consumer loan contract complies with the requirements set out in the Credit Institutions Act as applicable at the time of contracting, even if the written contract specifies the loan amount in HUF, provided that the foreign-exchange equivalent of the loan amount so specified can be calculated precisely at the conversion date set out in the contract, or on disbursement, at the rate applicable on that date. This decision is consistent with the Curia's earlier civil uniformity decisions, the settlement acts (*Acts XXXVIII and XL of 2014*), and the evolving judicial practice.

In 2016 the Ministry of justice prepared for **a major overhaul of the Civil Code and the related legislation**; however, the package submitted to the Parliament contained significantly reduced proposals and so, in addition to the re-regulation of *financial contracts*, the amendment of the

Collateral Register Act has also been postponed. *Act LXXVII of 2016 on the Amendment to the Civil Code* amended the provisions of the Civil Code for the senior management of legal entities, as well as the regulation of guarantees, liens, and collateral securities. The securities chapter of the Civil Code was reworded with a view to the alignment of the *Capital Market Act* and the Civil Code. The reintroduction of the instrument of independent liens is particularly important in terms of the recovery of the refinancing market, cleaning bank portfolios and increasing the security of the mortgage bond market. Amendments affecting liens, effective as of 1 October 2016, enabled the conversion of existing liens established on property in lien contracts, and of seceded liens, into independent liens. **The creation of converted independent liens** was a precondition for the affected banks to be able to comply with the provisions of the MNB regulation *on the forint maturity adequacy for credit institutions* (commonly called the mortgage loan funding adequacy (JMM) regulation). The amendments provides the legal opportunity to make refinancing (part) of the stock possible at the credit institution's discretion, with the important guarantee that the situation of the lienor cannot become more burdensome by the conversion. To facilitate this conversion process, the MNB developed a standardised customer notification, with the involvement of the affected banks, for consumer protection purposes, which includes the credit institution's statement on the conversion, and provides clear information about the rules and consequences of conversion. (Including that the central bank had already introduced stricter regulation on the JMM ratio before the entry into force. These stricter standards must be complied with as of 1 October 2018.)

In 2016, one of the most **important legislative changes** was the amendment of the *Act on Integration of Cooperative Credit Institutions*, which, amongst other aims, reinforced the MNB's supervisory role, broadened the powers and competences of the Integration Organisation, and extended the joint and several liability of the integration to claims on the National Deposit Insurance Fund (OBA). At the same time, the *comprehensive review of Act CV of 2015 on Debt Settlement Procedure for Private Individuals (Act on Private Bankruptcy)* was not on the agenda, despite often expressed needs to this end, and the *Government Decree on the Sale of the Debtor's Assets* also remained a draft only. *Electronic communication with courts* (e-litigation gate) started its operation with the deadline specified by the law. The implementation of the 4th AML Directive, and the drafting of a new *Act on the fight against money laundering* is due in the first part of 2017.

In view of the experience gained during the application, the **Hungarian National Bank** amended its decree on the *PTI ratio*. With two decrees and a recommendation, it put into international context the *credit risk management rules*, issued a recommendation on the *application of general consumer protection principles*, as well as *product oversight and governance arrangements for retail money market products*. In addition, the MNB developed a draft recommendation for *the out-of-court settlement of non-performing corporate loans*, and for the *remuneration* of bank decision makers, using the Guidance from the European Banking Authority. In cooperation with the Hungarian Forex Association and the Hungarian Banking Association, it transformed the quoting of *reference interest rates*, and took over the related administrative tasks.

In the field of **payments**, the introduction of the *Payment Accounts Directive* (mandatory opening of basic accounts, and bank account switching) caused difficulties due to the very short implementation deadline. This Directive covers the regulation of the comparability of fees related to payment accounts; however, its implementation is likely to be postponed until end-2017. After the smooth implementation of the *SEPA End Date Regulation*, Hungarian banks started preparations for the implementation of the *new Payment Services Directive (PSD2)*. The organisation efforts by the Hungarian Banking Association greatly contributed to the creation of a solution ensuring the bulk change of *direct debits* that became necessary due to switches in public utility service providers. Despite MNB's preliminary plans, the exchange of *20 thousand forint banknotes* was not completed last year. In the *bank card business*, apart from the penetration of contactless cards, it is worth mentioning the very low occurrence of fraud events, even by international comparison.

It was an important development in 2016 that the Hungarian Banking Association undertook, at the request of its members, to perform the tasks of the *SWIFT national user and member group*. The development of the *SCT Instant Credit Transfer Scheme* was a priority task for the European Payments Council. MNB has already made first steps for the implementation of the *Instant Credit Transfer Scheme* in Hungary

In terms of taxation, the most significant change for banks was *the decrease in the banks' special tax*, in line with an earlier agreement, and the imposition of a *special tax on investment services and financial lease activity*. In the **accounting field**, the most important development is the postponement of the mandatory migration to IFRS by one year.

The finalisation of the reform package decided on in the wake of the financial crisis was planned by 2016 in **global regulation**. In view of this, the *Financial Stability Board (FSB)* dealt primarily with the completion of the regulation of the too-big-to-fail issue, under which it updated the methodology for the identification of global systematically important banks (G-SIBs); it added standards on internal TLAC requirements into the methodology for the determination total loss absorbing capacity (TLAC), and issued numerous documents on cross-border resolution that help resolvability. In addition to facilitate consistent and full implementation of reforms, the FSB's key priorities for 2016 were the establishment of a new resolution framework for central counterparties; management of new and emerging vulnerabilities in the financial system; analysis of the practical application of macro-prudential policy frameworks; and the evaluation of systemic risks arising from financial technology innovations and operational irregularities.

The *Basel Committee for Banking Supervision (BCBS)* intended to complete the programme on the management of excessive volatility of risk-weighted assets by the end of 2016. As part of the balancing simplicity, comparability and risk sensitivity across the regulatory framework programme, it revised the rules and capital requirement for market risk management, the capital requirement for operational risks, and it launched a consultation on the review of IRB approaches used for setting capital requirements for credit risks, with a view to decrease the number of model variations. The completion of the Basel III regulatory package contained the revision of Pillar III, the disclosure framework; the finalisation of the leverage ratio; management of the banking book interest rate risk; review of the securitisation framework, setting capital requirements for simple, transparent and comparable securitisation; and the finalisation of the TLAC regulation. At the same time, the amended rules restricting the use of IRB approaches caused an unjustified increase in capital requirements, which is not acceptable for the industry, mainly for European banks. As such, no agreement was reached on the finalisation of the Basel III package; in the first days in January, it was announced that the Committee needs more time to finish the work and for the final quantification.

The general framework for **European regulation** was substantially determined by the uncertain political environment, namely the referendum that decided on Great Britain's exit from the EU and the internal tensions related to the refugee issue. Despite the unfavourable environment, bodies in charge of facilitating regulation (i.e. the Commission and the presidencies) sought to comply with the pre-set priorities and the demand to accelerate reforms and to keep legislation on its normal course. At the beginning of the year the Commission *under the Better Regulation Agenda* launched the *REFIT Programme*, aiming to make EU legislation more simple, effective and cheap. Based on the outcome of the *Call for Evidence on EU financial services*, the Commission concluded that no change is necessary in the EU regulatory framework for financial services, but action is needed to eliminate unnecessary regulatory constraints that hinder the financing of the economy, to improve the proportionality of the rules, to reduce the unnecessary regulatory burdens and to strengthen the consistency of the rules. Based on these criteria, the European Commission developed its *proposal on the conclusion of the Basel reform package's implementation*, which contains the amendments to the

Capital Requirements Regulation and Directive (CRR/CRD4), the *Bank Recovery and Resolution Directive (BRRD)* and the *Single Resolution Mechanism Regulation (SRMR)*.

The 2016 EU ambitions focused, in addition to deepening the Economic and Monetary Union, on the reinforcement of the Banking Union and the establishment and development of the Capital Market Union. In terms of the pillars of the Banking Union, under the *Single Supervisory Mechanism (SSM)* the European Central Bank is in charge of the direct supervision of significant Eurozone banks in an increasingly smooth, professional manner. The *Single Resolution Mechanism (SRM)* only became fully functional in 2016, but achieved important result in the fields of resolution planning and developing the reporting on bail-inable instruments. In 2016 the Member States (Council) and the Parliament focused on the establishment of the *European Deposit Insurance Scheme (EDIS)* but it is unlikely that this scheme would be set up in the form and according to the schedule envisaged by the Commission.

Completing the *Capital Markets Union (CMU)* as soon as possible plays an important role in the promotion of the final goals of the Commission, growth and employment.

II. Macroeconomic outlook, operational environment of the banking sector

In 2016, the **development** of the **global economy** was unbalanced; growth generally slowed down in the first three quarters of the year, although this trend seems to reverse as of the last quarter of the year. As such, although it was still at an unchanged low level, the world economy was growing in a slightly accelerated manner at the end of the year. According to the latest IMF forecast for January, annual GDP growth in 2016 was 1.6% in the United States, 1.7% in the Eurozone, 0.9% in Japan and 6.7% in China. Compared to previous forecasts, growth accelerated in the United States and slowed in Japan. For 2017, the institute expects growth in the United States of 2.3%, 1.6% in the euro area, 0.8% in Japan and 6.5% in China, while the Russian economy is set to slow further, at the expected rate of -1.2%.

During the year several important political events took place that influenced the global economy to a great extent. In June, Brexit brought an unexpected result in the United Kingdom; voters decided to leave the EU. Market players were kept in a state of long-term uncertainty by the procedure initiated at the British Supreme Court, on the entity entitled to submit the exit declaration, which was completed only in December. Other than the plummeting British pound, no other data showing or suggesting a recession in the UK economy came to light. Economic expectations were also greatly influenced by the presidential elections in the US, both by the issues raised by the future president during the campaign and by the election of Mr. Trump in November. Although the protectionist rhetoric of the new president makes a set-back in global economic relations likely, the effect on capital markets does not reflect expectations.

During the year, **the monetary policy pursued by the central banks of global importance** changed in various directions. After the 25 bps base rate increase in late 2015 by the Fed, it increased the base rate again by 25 bps at its December 2016 meeting, and another three increases are foreseen in 2017 by FOMC¹ members. The European Central Bank has extended its bond purchase scheme. Japan has made no adjustments to its existing programmes, enabling additional asset purchases to be made.

The economic growth in the **United States** continued to be driven by growth in the labour market and, via this, high domestic demand. Despite the more moderate growth compared to earlier years, the economy is in good shape, but exports are still unable to feed economic growth.

The growth trend of previous years continued in the **European Union**, i.e. an increase in slowly recovering GDP, decreasing the output gap. Employment data showed a significant improvement during the year, and this had a positive influence on internal demand via rising wages. The key external and internal risks for development were the slow-down of the Chinese economy, the negative short-term effect of immigration and expectations following the Brexit decision. At the end of the year, stability was compromised by the outcome of the US presidential election, the referendum in Italy that rejected constitutional reform and thus overthrew the Government and the unresolved refugee issue.

In Japan, due to monetary easing, the fiscal stimulus and invigorated net exports resulting from the weakening Yen, some improvement can be observed in the growth data. However, growth is greatly held back by falling real wages caused by fixed salaries despite the low inflation, and this has a negative effect on consumption.

The slow-down of the **Chinese economy** continued. Due to the central bank's measures, the Chinese currency did not weaken but this depleted the country's foreign reserves. The strong renminbi had a negative effect on export performance. The high indebtedness and worsening creditworthiness of Chinese companies poses a significant risk and exerts pressure on monetary policy. However, a positive development is that administrative measures succeeded in controlling the growing real estate bubble.

In line with expectations, **Russia** succeeded in overcoming the nadir of its recession. The exchange rate of the rouble was stabilised, inflation is moderating, the central bank started a slow monetary easing and the country returned to the international capital markets after three years. The

¹ Federal Open Market Committee; the Fed's body for monetary decision making

sustainable increase in oil prices also support budgetary balancing and economic recovery. The key issue is the lack of international investments, since diversification of the current monoculture economy is essential.

After a weak start to the year's performance, **the growth** of the **Hungarian economy** showed promising signs, then returned to a downward path in the second half of the year, and by the end of 2016 it fell to 2% on an annual average from 3.1% in the previous year. Market services and agriculture contributed to this growth to the greatest extent. Industrial performance stagnated, and the growth in the construction industry continued to be modest, despite the Government's home creation scheme. On the consumption side, household consumption was a growth driver, while investments continued to show a decline. It was a surprise that external trade also held back the growth rate, but presumably only to a small extent. In 2016, the modest growth rate compared to the preceding two years was, apart from the stagnation of industry, primarily attributable to the fact that investments related to EU assistance ramped up more slowly than expected.

Year-on-year **employment** increased by some 140,000 people. It reached 66.5% of the working age population, which was 2.6% higher than in 2015. The lack of a qualified workforce is becoming an issue in an increasing number of sectors (construction industry, hospitality, tourism); companies are forced to raise wages significantly to retain a qualified workforce.

To decrease wage pressure, the Ministry for National Economy agreed with the national employer and employee associations to decrease the employer's contribution on wages by 5+2% in two years (in 2018 by +0.5 above a certain wage increase rate).

In terms of **balance indicators**, the position of the **budget** remains extremely favourable, with high revenues from nearly all taxes. The annual cash deficit of HUF 848 billion corresponds to 2.4 per cent of GDP. In the period from January to November, the budget had accumulated a surplus, and the deficit of the annual budget was solely attributable to the HUF 900 billion deficit recorded in December. Presumably, the deficit was mainly due to the Hungarian State's funding of EU projects instead of the EU. By the end of 2016, public debt had been reduced below 74 per cent of GDP, a trend that may also continue into the next two years. Households' direct share in government bonds passed the 20 per cent mark, a significant pick-up compared to the 2 per cent recorded in 2010. Approximately 25 per cent of the public debt is denominated in foreign currency. Overall, the country became significantly less vulnerable.

In 2016 **consumer prices** increased by 0.4% on average, compared to the previous year's level. The main role in this increase was played by rising fuel prices. (The acceleration of inflation is suggested by the fact that, in December 2016, consumer prices were on average 1.8% higher than those of December 2015.) Core inflation remained solidly below 2%; no inflation pressure can be identified in the economy on this basis.

In the first half of the year, the central bank decreased the **base rate** from 1.35% to 0.9% and kept this level in the second half of the year. Parallel with this, it decreased the deposits that can be held in a **deposit facility**, thus significantly amending the banking environment. This measure aimed to channel the liquidity held with MNB to other money and capital markets (lending, sovereign bonds) and, as a secondary goal, to exert downward pressure on market interest rates. As of August, the central bank made deposit raising tenders less frequent and then, in the September meeting of the Monetary Council, it set an end-year cap of HUF 900 billion for the then HUF 1.800 billion portfolio, and it further narrowed it by HUF 150 billion in its December meeting. In the new scheme, the MNB supports the management of the more abundant liquidity by the flexible provision of overnight deposit and central bank lending facilities, and forint provision swaps.

During 2016, the **aggregated balance sheet total** of **credit institutions** increased by 4% in nominal terms (by HUF 1,316 billion) and passed the HUF 34,000 billion level. This increase was associated with a change in the currency composition; subject to a nearly identical exchange rate then in late 2015, the significant increase (+25%, HUF 1,485 billion) in EUR stock and over 20% increase (HUF 496 billion) in other foreign exchange stock faced a 2.7% (HUF 665 billion) decrease in forint stocks.

On the **liabilities side**, deposits and equity increased while the portfolio of securities issued by banks decreased. In the first half of the year, alongside the less intense decrease in domestic funds, foreign funds increased significantly, but in the second half of the year a contrary movement could be seen, which increased the proportion of domestic funds significantly by the end of the year.

The *deposit portfolio* increased significantly (+8.7%, HUF 1,468 billion). The average duration of fixed term deposits continued to become shorter during 2016, which is mainly due to the decrease in the fixed term deposits up to one year maturity; no substantial change occurred in the portfolio with maturity exceeding one year. The most significant quantified effect was exerted by the HUF 584 billion (9.9%) increase in deposits from non-financial corporations, but the portfolio of deposits from the general government (+26.8%, HUF 223 billion) and not-for-profit organisations (+48.7%, HUF 188 billion) also increased substantially. The portfolio of household deposits increased only moderately (+2.9%, HUF 199 billion), and so the total deposits from non-financial corporations nearly caught up with the household portfolio.

No material change occurred in *interbank liabilities*; the decrease in interbank deposits (HUF -139 billion) was compensated by interbank borrowing (HUF +120 billion).

The *portfolios of debt securities* issued by banks held by residents and non-residents both decreased, by 23.1% (HUF 318 billion) and 29.7% (HUF 514 billion) respectively.

In 2016, the aggregated equity of credit institutions grew by 25% (HUF 727 billion). This is due to significant increase in the profit reserves and the profit for 2016, while the subscribed capital and (due to the associated premium) the capital reserve decreased by HUF 159 billion altogether. The capital adequacy ratio of the sector was 20.1% at the end of the third quarter.

The main driver for the increase in the **asset portfolio** was the expansion of the loan portfolio (+13.5%, HUF 1,985 billion), and the restructuring supported by the MNB self-funding scheme, from central bank deposits (-45.3%, HUF 1,935 billion) towards sovereign bonds (+13.9%, HUF 886 billion). As a result of another marked restructuring, exposure to domestic customers decreased significantly (by HUF -1,200 billion) and foreign exposures increased to an even greater extent (+ HUF 2,100 billion).

The *total gross loan portfolio* grew by 9.2% (HUF 1,502 billion) in nominal terms: 36% of this increment is denominated in forint and 42% in euro. The internal structure of the loan portfolio changed in a particular manner. This increment was primarily due to disbursements to domestic financial institutions (+19%, HUF 499 billion) and foreign customers (+100%, HUF 1,346 billion, of which HUF 576 billion was to financial organisations). Lending to private entrepreneurs with higher income content grew dynamically (+70.3%, HUF 148 billion), while gross exposure decreased in other segments. This decrease is minor for non-financial corporations; however, despite the positive turn in the trend associated with the issue of new loans, there was a 6% (HUF 338 billion) fall for households. The portfolio of personal and consumer loans, with greater risks but shorter term, although negligible within the portfolio, grew (+17.1%, and +49.8%); however, the mortgage loan portfolio, making up most of the portfolio, declined by 8% (HUF 379 billion).

The *impairment* stock decreased in each customer segment, by nearly 30% in total (HUF 482 billion).

As a combined effect of the above, the *net loan-to-deposit ratio* of the credit institutions sector changed from 87% at the end of the previous year to 91%.

With regard to **profit, operating income** (interest, fees and commissions, and income from financial operations) developed positively: all in all it grew by 12.5% (HUF 169 billion), the main contributing factors to which were the HUF 80 billion increase in income associated with securities and participations, and the HUF 70 billion increase in net conversion income from foreign exchange and currency transactions. Of this, one part is one-off items, and the other part is rather volatile and so it provides no constant source of income for the industry in the long term. For interest rate income, a detrimental trend for banks continued: in a falling interest rate environment, interest income from lending decreased more than interest expenses. It is also unfavourable that, despite customers' increasing economic activity, fee and commission income that does not require capital was unable to grow substantially.

In 2016, **pre-tax profit** was outstandingly good compared to the previous year, reaching HUF 510 billion; the average pre-tax return on assets (ROA) of the banking industry was +1.5%; and its return on equity (ROE) was +15.7%, resembling the indicators of the years preceding the crisis. However, the high profitability ratios are largely attributable to single factors and those unrelated to the operations of the Hungarian banking system (release of impairment provisions, sale of Visa Europe shares by several banks, dividends from foreign subsidiaries). Over the medium term, the persistently large portfolio of non-performing loans and the environment of low returns have a negative impact on the profitability of the banking system in Hungary as well.

III. Corporate lending – Results of the Funding for Growth Scheme (FGS)

Between 1 January to 30 December 2016, credit institutions participating in Stage 3 of the scheme reported data on HUF 473 billion worth of contracts in relation to 16,628 transactions and 11,024 enterprises. Of the contracts made in Stage 3 ending 30 December 2016, 76.5% are new investments loans, and 23.5% are new lease transactions. (Stage 3 is limited to these types of financing; working capital finance and replacement loans are not available.) Of the HUF 320.4 billion worth of contracts made in Pillar I, available for forint lending, investment loans amount to HUF 239.4 billion, and lease transactions to HUF 81 billion. Of the HUF 152.3 billion (~EUR 488 million) worth of contracts made in Pillar II, available for foreign exchange lending, investment loans amount to HUF 122.2 billion (EUR 391.3 million), and lease transactions to HUF 30.1 billion (EUR 96.7 million).

In Pillar I, the average maturity, weighted by contract amount, is 7.9 years – 9 years for new investment loans and 4.8 for lease transactions, whereas in Pillar, the average is 8 years – 8.9 years and 4.1 years respectively for the two forms of financing.

In the years following the crisis, between 2009 and 2013, the volume of lending dropped by 4-5% annually, mostly affecting the SME sector. To aid the sector, in 2013 the MNB resolved to launch the Funding for Growth Scheme, which from 2013 onwards stabilised lending to the domestic SME sector, setting it on a growth path by 2015. In the three stages since 2013, a total of approximately 38,000 businesses gained access to favourable funding of about HUF 2,600 billion. Simultaneously with the phase-out stage of the FGS, in 2016 the MNB launched the Market-Based Lending Scheme (MLS), as part of which it established an incentive system for long-term market-based lending by means of interest rate swaps with commercial banks. In line with expectations, by the end of 2016 the volume of market-based HUF transactions also returned to positive territory. According to preliminary data from the MNB, lending to SMEs including the self-employed grew by approximately 12% in 2016. As a combined result of these developments, the MNB's lending incentive schemes are estimated to have contributed to GDP growth by an annual average of 0.6% between 2013 and 2016.

According to the MNB's forecast, in the coming two years, even after the FGS is closed, SME loans may continue to grow at a rate of 5-10% in support of sustainable economic growth. Credit guarantees may take on a more prominent role, which, through the increased activity of guarantee organisations, may further support the upturn in SME lending. Additionally, significant amounts in both non-reimbursable and reimbursable grants from the EU are available to the domestic SME sector, and due to the interest rate cuts applied in recent years, market-based credit products from credit institutions are available under increasingly favourable terms. The MNB expects that in the coming years, the funding requirements of SMEs can be satisfied on a market basis in sufficient quantity.

IV. Retail lending

Decree on state housing subsidies (CSOK)

In February 2016 the Government introduced additional preferential terms to the rules of housing subsidies taking effect at the beginning of the year:

- For new apartments, the price cap on the eligible apartments was removed; the person receiving the allowance is allowed to keep their previous property and it is not compulsory to use the revenue from a property sold within five years to purchase the new property. Cohabitees and single parents received further allowances in the access to the subsidised loans.
- For used apartments, the amount of the state grant was further increased, and only a lower floorspace threshold was prescribed for the apartment to be purchased.
- Although it was a formal amendment, the fact that the set of rules earlier incorporated in four decrees was redrafted in two decrees, one for new and one for second-hand apartments, providing a significantly better overview for all stakeholders.

To facilitate the better manageability of changes affecting housing loans, the Banking Association organised a consultation, where bank experts could discuss the details of the regulatory amendments with the officials in the competent department of the Ministry for National Economy (NGM). A detailed memo was drafted about the consultation to help the everyday practice of lending, which also included authority answers to previously collected questions.

Regarding the correct application and interpretation of the legal regulation, a number of proposals and questions were also raised following its amendment in February, leading the NGM to prepare new draft amendments to the Decree, under which

- property in undivided joint ownership became eligible for the grant (including with retroactive effect);
- for construction purposes, although temporarily, the grant became available to cover costs, also with retroactive effect, and
- the draft widened the range of eligible grant purposes to include construction works in respect of which a building licence has been issued, but an occupancy permit has yet to be obtained.

In its opinion sent to the Ministry, the Banking Association welcomed the directions of change, while it also made a number of comments. Among other aspects, we made the following recommendations:

- beneficiaries of the retroactive effect should be eligible for a free second procedure only if they have already paid banks' fees on the first occasion;
- in respect of homes acquired using the grant, the period during which the ownership of homes is restricted to beneficiaries should be limited to the period of constitution of restraint on alienation and encumbrance on behalf of the state.

Following lengthy inter-ministerial negotiations, in September 2016 amendments to the CSOK decrees were issued, which also included the adjustments supported by the banks. Following the best practice, after the amendments were issued, a number of regulatory positions were also issued in response to the questions raised by banks or the Banking Association, to clarify the interpretation of the decrees.

During the year, banks concluded approximately 23,000 CSOK contracts, under which HUF 66 billion worth of grants were disbursed. There was obviously significant growth in lending linked to the grants.

Consultations on the interpretation of domestic legislation transposing the Mortgage Credit Directive

Following the promulgation, in late 2015 and early 2016, of the consumer credit acts and their implementing decrees transposing the Mortgage Credit Directive, our members indicated that it would be important to clarify with the responsible Ministry the interpretation issues raised before the application of these laws in March. We received useful guidelines from the Ministry for National Economy before the application date of the legislation at the end of March, but the required legislative changes could only be made subsequently.

During this consultation process we achieved that

- employees responsible for the examination of creditworthiness and involved in the loan decision are not excluded from the incentive opportunities (they can be granted bonuses, for example, based on the number of customers they deal with or for their faultless work, but their remuneration cannot depend on the number and proportion of accepted loan applications),
- amendments are made to the regulations that would have required the same complicated and expensive conversion rules to original HUF loans as were applicable to foreign exchange-based loans,
- specialised credit institutions not entitled to keep payment accounts can require their debtors to open free accounts, although with other banks, to service their debts,
- the legislator clarifies that the new commission cap (2%) introduced for loan agents applies only to contracts concluded after the entry into force of the legislation.

On the subject of interpreting the relevant legislation, also in the application period of the Decree, banks continued to submit questions and comments, to the majority of which the NGM provided explanatory guidelines or positions.

Uniformity Decision No. 1/2016 PJE of the Curia

The uniformity procedure conducted by the Civil Division of the Curia provided an answer to the question whether a contract where the amount of the loan to be disbursed in HUF is specified in HUF, and the foreign exchange amount of the contract is included in a separate document (e.g. disbursement notice, repayment plan) that constitutes a part of the contract and is prepared subsequent to contracting as agreed by the parties, qualify as valid foreign exchange-based consumer loan agreements.

Adopted on 6 June 2016, *Decision No. 1/2016 PJE of the Curia* takes the position that a foreign-exchange based consumer and retail loan contract complies with the requirements set out in the Credit Institutions Act as applicable at the time of contracting even if the written contract specifies the loan amount in HUF (payment currency), provided that the foreign-exchange (calculation currency) equivalent of the loan amount so specified can be calculated precisely at the conversion date set out in the contract, or on disbursement, at the rate applicable on that date. A contract also complies with the requirements of the Credit Institutions Act if it specifies the number of instalments, their amounts, and the repayment dates in a calculable manner. Instalment amounts qualify as calculable if the contract specifies at least the data and calculation method based on which the instalment amounts can be determined precisely at a subsequent conversion date as set out in the contract, or where no such date is available, on the due date of each instalment. If the contract includes the above, a unilateral statement (such as a disbursement notice, repayment plan or payment schedule) made subsequent to contracting will qualify as information supplied by the financial institution to the consumer, which does not affect the formation or validity of the contract.

The PJE decision is consistent with the Curia's civil uniformity decisions adopted in 2013 and 2014, the settlement acts (Acts XXXVIII and XL of 2014), and the judicial practice shaped by those decisions and acts.

V. Further important regulatory developments influencing the operation of the banking sector

Amendments to the Civil Code and related legislation

In the context of preparations to amendments to the Civil Code, we held several discussions to review regulatory proposals for *financial contracts* (*payment account contracts*, and *lease and factoring contracts*). We made an itemised proposal for normative text on these contract types, including explanatory notes, and we also made detailed comments on the version distributed to the Ministries for consultation. Of the proposed amendments reviewed by it, the Government submitted only a significantly reduced part to the Parliament, as a result of which no amendments were made to legislation on financial contracts and the *Collateral Register Act*.

Act LXXVII of 2016 amended the provisions of the Civil Code for the senior officers of legal entities, as well as provisions for liens and collateral security. In the latter context, the instrument of independent liens was reincorporated into the Civil Code. The securities chapter of the Civil Code was reworded with a view to the alignment of the Capital Market Act and the Civil Code. At the same time, the open concept of securities is to be maintained to provide opportunities for capital market innovations. The invalidity of fiduciary collateral has been maintained in the context of consumer transactions. Under the revised rules on contract transfers, the security of any claim transferred to the party entering the contract shall remain in effect. Security for fulfillment of an obligation accrued upon the party entering the contract shall cease to exist, except if the obligor of the security gave consent for the transfer of the contract. We consider the reintroduction of the instrument of independent liens as particularly important in terms of the recovery of the refinancing market, cleaning bank portfolios, and increasing the security of the mortgage bond market. *Act LXXVII of 2016* amending the Civil Code took effect on 1 July 2016; however the amendments concerning liens and the rules of securities only became effective as of 1 October 2016 and 1 January 2017, respectively. Under the revised rules, assets that may be pledged as collateral security including receivables from deposit contracts (bank account balances). The rules on the enforcement of liens have been revised. On the lienholder side, the reintroduced contracts for independent liens can only be concluded by financial institutions, and independent liens can only be placed on real estate. The essence of independent liens is the absence of legal additionality, i.e. independent liens are placed on pledged assets independently of secured claims. Independent liens can be transferred to other financial institutions, and to ensure marketability, transfers can also be made without the secured claims. Lienors are protected by law against repeated enforcement of the same claim. The exercise of the right to satisfaction is regulated in the lien contract, the required contents of which are set out in the Civil Code.

Establishment of converted independent liens

The act amending the Civil Code enables the conversion of existing liens established on property in lien contracts, and of seceded liens, into independent liens referred to as converted independent liens. The conversion is made by means of the lienholder financial institution's unilateral statement to the lienor.

The reintroduction of the instrument of independent liens into civil law was of particular importance in terms of refinancing and for compliance with the mortgage financing adequacy ratio (the MNB MFAR Decree)². The amendment provides the conditions for refinancing (part) of the stock at the

² MNB Decree No. 20/2015 (VI. 29.) on the forint maturity match of credit institutions

credit institution's discretion. A key guarantee in conversions is that no conversion can be made to the detriment of the lienor. Converted independent liens may be registered up to the "amount" specified in the original lien contract.

The conversion process also involved other legislation and the development of normative documents; consequently, the rules set out in the Civil Code Amendments Act were followed by amendments to *Act CXLI of 1997 on Real Estate Registration* and other implementing decrees, and the MNB also developed standardised customer notification for consumer protection purposes. Standardised customer notification includes the credit institution's statement on the conversion, and provides clear information about the rules and consequences of conversion.

As the final step of conversion, banks initiated customer notifications and Land Registry entries at the end of 2016 to comply with the deadline of 1 April 2017 as set out in the MFAR Decree.

Developments and practical issues in personal bankruptcy

Act CV of 2015 on the Debt Settlement Procedure for Private Individuals was amended twice after its adoption, but the need for a comprehensive review also emerged. To that end, we had several consultations with the Ministry of Justice, as part of which we made a comprehensive proposal for amendments, and commented on the Ministry's extensive legislative package. As opposed to initial intentions and expectations, the April amendment only extended the deadline for the submission of the procedure until 30 September 2016, and the submission of a more extensive proposal for amendments was postponed.

We have provided opinions in several rounds on the *draft Government Decree on determining the market value of the debtor's assets* related to the debt settlement procedure for private individuals. Within the meaning of the proposal, the sale of the debtor's assets as set out by the law must be performed at arm's length, in a public and transparent manner. For high-value movables and immovable property, this means the use of the online electronic auctioning system (EAR) operated by the Hungarian State Holding Company. In the court debt settlement procedure, the tasks of the seller are performed by the family administrator appointed for the family.

In our comments on the draft, we made proposals to make the procedure more market-based, and we made some proposals to protect the interests of lenders. Although it falls outside the regulatory scope of the Decree but is closely related, we reiterated the issue that in the context of personal bankruptcy procedures, the closure of the enforcement procedures in progress is unregulated, and the conditions are not provided for the buyer in a personal bankruptcy procedure to acquire unencumbered property.

We collected the practical issues related to the application of the Personal Bankruptcy Act, and submitted them to the Ministry of Justice. We initiated consultations involving the Family Bankruptcy Protection Service to address the following agenda items: simplification of the submission documentation, assessment of authority to initiate a procedure, electronic communications, obligation to supply missing information and reconcile data, starting date of access to a repayment subsidy, issues related to environmental studies, publication of notices on the website, searching, etc. A majority of the issues raised were settled, and the Office of Justice published a methodology recommendation on those issues, consulting the Banking Association on the draft of the recommendation.

No meaningful progress was made in 2016 concerning amendments to the Act, and the decree on the sale of assets.

Amendments to the act on the integration of cooperative credit institutions

In summer 2016, the Parliament adopted *Act LV of 2016 on amendments to specific acts in connection with the integration of cooperative credit institutions*. Among other provisions, the amended Act reinforced the MNB's supervisory role, broadened the powers and competences of the

Integration Organisation, and extended the joint and several liability of the integration to claims on the National Deposit Insurance Fund (OBA).

Other than broadening its powers, the amendments also conferred additional specific supervisory powers on the supervisory authority (MNB): in the event of a reduction in the solvency capital of a cooperative credit institution, the MNB may require the stabilisation of the institution's capital structure, and the sale of its assets. Within the meaning of the amendments, the Board of the Integration Organisation may decide, subject to the prior approval of the supervisory authority, on the admission of a cooperative credit institution to the Integration Organisation, and its exclusion.

The amendments significantly *reinforced the powers of the Integration Organisation (CCIO)* vis-à-vis Takarékbank, which acts as the Central Bank. As of the summer, the mandatory regulations concerning members have been approved by the Integration Organisation. At the same time, the list of required regulations is also extended, as a result of which the powers of the Integration Organisation will also include the approval of regulations on additional capital requirements and informational technology standards. Going forward, the Central Bank acting within its powers related to the integration of cooperative credit institutions will be supervised by the Integration Organisation. In order to ensure that operations are compliant with its guidelines, regulations and previous orders, the Integration Organisation issues binding orders for cooperative credit institutions and the Central Bank.

Representing one of the key changes, the integration is given wider responsibilities, and previous unreasonable restrictions are removed. Within the meaning of the amendments, the Integration Organisation, the Central Bank and cooperative credit institutions have joint and several liability for all obligations, irrespectively of when they arise.

Electronic communication with courts

In the amendment to *Act III of 1952 on the Civil Procedure (Civil Procedure Act)* at the end of 2015, the deadline for the introduction of mandatory electronic communication with courts was postponed to 1 July 2016: for customers retaining legal representatives, and for resident economic entities, including banks, communication with courts is strictly electronic. (Applications as well as any other petitions and documentary evidence must be submitted to the courts electronically, using the form submission support service.) The revised rules are set out in the *Civil Procedure Act* and in *Government Decree No. 83/2012. (IV.21.) on regulated electronic administrative services and on the services to provided by the state on a mandatory basis*.

The Banking Association initiated the introduction of an electronic company gateway for the corporate and legal representatives of resident economic entities for communication with the courts, based on the example of official gateways, rather than using their own personal client gateways for this purpose, thus providing access for several employees and representatives of the business entity. The Banking Association accomplished the setup of an e-action gateway service in addition to the client gateway and the official gateway, which enables electronic communication for business entities and law partnerships.

To support preparations, we set up an ad-hoc working group, and participated in several consultations in the Ministry of the Interior, the National Court Office and the Hungarian Law Association.

Proposal for amendments to the Money Laundering Act

The Fourth Anti-Money Laundering Directive must be transposed to national legislation by 26 June 2017. According to the information provided by the Ministry for National Economy, the Government is planning to comply with this obligation by drafting a new anti-money laundering act, which will also include provisions called for by the main findings of the MONEYVAL's country report. In addition to the new act, specific regulations are expected to be set out in an NGM decree and an MNB decree.

With a view to supporting legislation, in autumn 2016 the anti-money laundering working group compiled comments based on recent years' practical experience, which it submitted to the Ministry for National Economy. The main themes which, on the basis of practical experience from the past years, the working group considers fit for a review, include, without limitation, all three versions of customer due diligence (extensive, simplified, normal), the identification of beneficial owners, and the prohibition on disclosure of information on the notifications to the customers. Feedback indicates that amendments will be made to two provisions that have long posed problems for the sector. This will provide the statutory grounds for the copy of documents for identification purposes, and the superseding of the principle of declaration in the case of PEP declarations (customers' declarations on their status as politically exposed persons), allowing institutions to record politically exposed persons as such based on information obtained from other sources.

VI. Developments relating to the National Bank of Hungary (MNB)

MNB Recommendation on the recovery of retail mortgage loans in default

In March 2016, without any meaningful preliminary consultation, the MNB put into effect its *Recommendation* indicated in the title. The Recommendation provides for the completion of an extremely complicated, time-consuming and costly procedure by the lender in order to restore the solvency of the debtor, before terminating a defaulted loan or, for already terminated loans, before selling that loan. The ultimate goal of this is to develop a long-term payment solution, together with the customer, and for this purpose the lender must use all available means to enforce cooperation (numerous notifications via phone/letters, extraordinary information requests, assessment of income and assets).

The MNB gave priority to issuing this Recommendation for the following reasons:

- the approximately 140,000 non-paying customers pose a huge macro-prudential risk for the banks, and a social risk for the country that is hard to solve,
- the HUF conversion/settlement process has been completed, creating a clearer picture of the debtors' situation,
- the termination of the eviction moratorium can create new incentives for debtors' willingness to pay.

On every possible platform (in writing and also verbally in management and expert consultations), the Banking Association opposed the Recommendation on grounds of its poor conceptual foundations and specific errors in its content and wording, for the following reasons:

- the customers concerned had been contacted by the banks on numerous occasions, offering repayment easement, but, mainly for social reasons, mostly without success. This will not be changed by a complicated, costly and time-consuming campaign encouraged by the authority,
- its legal background is unfounded; the affected fundamental consumer rights must be regulated in laws (Civil Code, Credit Institution Act), while making the termination of the claim and selling the terminated claim conditional violates the banks' fundamental rights,
- assistance to the non-paying customer base might undermine willingness to pay among performing customers.

As a result of the Banking Association's firm action, and direct negotiations between the Board and the executive management of the MNB, limited results have been achieved:

- The FAQ issued by the MNB, which in effect serve as implementation guidelines, provided meaningful support for the parties implementing the Recommendation.

- The reporting obligation applies only to 60+ DPD transactions. (As a result, the Recommendation can be applied more flexibly to 30+ DPD transactions, placing less burden on the banks.)
- The complicated process set out in the Recommendation can be dispensed with in cases where the parties find a mutually acceptable solution at the time of the first contact.

As at 2016, it is too early to draw conclusions on the effect of the measure; however, initial data appear to confirm banks' concerns as the results are not commensurate with their significant efforts.

MNB draft recommendation for the out-of-court settlement of non-performing corporate loans

As a follow-up to their joint project launched at the end of 2014 to identify the legal, regulatory and interest-related issues that hinder the management of non-performing corporate loans, in late January the EBRD and the MNB organised a consultation on the management of non-performing corporate loans. One of its objectives was to promote, either by means of a review of the Budapest Principles established in 2009 within the framework of the Banking Association, or by setting up another set of voluntary rules, the incorporation of out-of-court corporate debt settlement based on cooperation between debtors and lenders into banks' practice on a large scale.

After the meeting, the EBRD commissioned consulting firm Ernst&Young to explore the issues related to efficient out-of court restructuring in detail, and put forward a proposal for their resolution. Involving 16 commercial banks, MARK Zrt. and the Banking Association, E&Y produced its study by late July. One of the key findings of the study was that the MNB should play an active role in promoting the efficient application of the out-of-court restructuring (OOCR) of defaulted corporate loans on the widest possible scale. The study also proposed that the MNB should support the process by issuing a recommendation.

The MNB sent its draft recommendation to the Banking Association, with a copy of the E&Y study attached, at the end of August. Our opinion on was formulated, and the tasks that could be undertaken by the Banking Association in the new OOCR environment were reviewed, with support from banks' competent experts and the representative of the law office that had played an active role in preparations for the Budapest Principles. We submitted our key comments to the MNB in early September, expressing criticism on the mandatory nature of the recommendation as a "soft" legal tool, the associated moral risk, the method and timing of its implementation, and its scope.

With the participation of all stakeholders, the MNB called a consultation, in which it explained that it would insist on introducing the recommendation, but would make a number of amendments to it based on suggestions from the Banking Association and the banks. The reviewed material was presented in the first week of October at a professional conference. At the event, speakers from both the MNB and the EBRD expressed their expectation that the Banking Association might act as a catalyst in the technical implementation of the recommendation. Speakers from the Banking Association continued to underline that efficient out-of-court corporate restructuring was not conceivable without the review and removal of the legal constraints of enforcement, bankruptcy and liquidation, which currently impede such restructuring.

Following the approval in principle of the Financial Stability Council, in early 2017 the MNB redistributed the draft of the recommendation for consultation.

Amendments to the decree on the payment-to-income ratio (PTI), application experience

Following consultations in August and November 2015 to fine-tune the PTI ratio, the MNB also held a consultation in the second half of January 2016, where with experts from the Banking Association and the banks it clarified the interpretation issued or raised earlier and submitted to the MNB.

Having obtained the ECB's opinion on the amended Decree, the MNB called another consultation with market players in early March. In the consultation, it explained that in the ECB's view, the 60% PTI ratio in respect of the total repayment burden should represent an effective limit even in cases where the instalments of loans with interest periods over 5 years are taken into account at 85% for the purpose of ratio calculation. The result of that in practice is that favourable consideration can only be given below the HUF 400,000 income limit.

Additional issues emerged in connection with the February draft of the FAQ and answers to be issued on the subject, as a result of which the final FAQ was issued in early April. Amendments to the Decree were put into effect by the MNB as of 1 May.

Amendments to the decree on the mortgage financing adequacy ratio (MFAR)

At the end of January, in response to our inquiry the competent regulatory department of the Ministry for National Economy indicated that it would address the implementation of securitisation rules in Hungary in compliance with Article 129 of the CRR only after approval of the Commission's draft regulations with respect to the capital market union. This made it clear that at the time of implementing the MFAR, only mortgage bonds would be available for compliance with the new rules. The MNB convened a consultation at the end of February for the retail and mortgage banks concerned, in order to review the legislative amendment process regarding the launch of the MFAR indicator and the state of play of the implementation by the banks. At this consultation, it was confirmed that the mortgage bank foundations announced earlier were well under way, but the pace of the legislative amendments lagged behind what was required.

To support the refinancing of existing mortgage loans, the Banking Association sent its proposals related to the key amendments to the *Mortgage Bank Act* in early April to the competent secretary of state at the Ministry for National Economy. The proposals were taken into account when the financial omnibus act was tabled at the end of April.

In late September, the competent deputy governor of the MNB announced in a consultation with bank CEOs that the central bank perceived a need for the further fine-tuning of the MFAR before its implementation, to be applied as of April 2018, involving the increase of the ratio from 0.15 to 0.3, the sector-level netting of mortgage bonds held in assets against mortgage bonds and refinancing mortgage loans recognised under liabilities, and the increase of the original maturity of mortgage bonds from one to two years. In our comments in early October, we made a proposal for the later application of a lower ratio, and the use of netting only above a certain threshold. The decree promulgated at the end of December eventually provided for the increase of the required rate to 0.2, to take effect 6 months later (as of 1 October 2018), but did not incorporate our proposal on netting.

Rearrangements in reference rate quotations

In order to strengthen their market character, in mid-February the MNB initiated rearrangements in BUBOR quotations by imposing a transactional obligation.

Following the compilation of proposals from the banks concerned, the amended MNB proposal was discussed by the Quotation Committee of the Hungarian Forex Association (ACIH) in its March meeting. The most important amendment was that the quotation obligation applied to 1- and 3-month maturities, and that BUBOR quotations were to be made at the rates submitted by quoting banks. The new rules also limited the amount and number of contracts to be accepted. The revised rules were incorporated into the ACIH's BUBOR regulations, which took effect as of the beginning of May. In the course of monitoring market processes, the MNB found that the new regulations had made market price discovery, which underlies quotations, more efficient, as a result of which the BUBOR had become permanently detached from the interest rate of the central bank's main policy instrument.

Following a review, in its March meeting, of the obligations resulting from the EU Benchmark Regulation, the Quotation Committee sent a letter to the MNB to offer the transfer of administrative duties related to BUBOR (and the reference rates BIRS and HUFONIA). At the end of March, the MNB issued a memorandum of understanding on the transfer as of 1 November, following which a new agreement was drawn up to terminate the tripartite cooperation agreement of June 2014 between the MNB, the ACI Hungary and the Banking Association on the quotation of the BUBOR, BIRS and HUFONIA reference rates, and to regulate the transfer of quoting administration to the MNB. Based on our questions, formulated jointly with the ACIH, the following provisions were incorporated into the agreement signed at the beginning of September:

- the use of BUBOR will remain free, and in the agreement the MNB declares the reference rates to be public goods;
- if subsequently the MNB were to prefer not to manage the administration of the above reference rates, the ACIH will have prior right to take over, and in the event that the ACIH were to prefer not to take over the administration of the reference rates, it is to be offered to the Banking Association prior to any other parties;
- the MNB will consult the market players concerned on professional matters relating to the reference rates.

Although the ACIH Quotation Committee remained in charge of the duties as per the previous agreement up to the date of the transfer (31 October), with a view to the smooth transfer of the administration of reference rates concerned and to ensure adequate professional governance following the transfer, the MNB set up its own Reference Rate Quotation Committee in advance, which held its inaugural meeting in late September. Committee meetings are attended by delegates of the ACIH Vocational Committee and the Banking Association's representative as permanent invitees.

The administration of the BUBOR, HUFONIA and BIRS reference rates were transferred seamlessly between the ACIH and the MNB on 1 November.

Developments on the regulation of remuneration

At the request of the Presidium of the Banking Association, the Human Resources Committee reviewed issues associated with the regulatory position adopted in the course of thematic supervisory audits conducted in 2015 on remuneration, following which it held an expert consultation with the supervisory area of the MNB. In the course of audits, the following issues of interpretation were raised in departure from the banking sector's position:

- disclosure obligation relating to individual employees' remuneration data;
- in connection with the reinterpretation of proportionality, the withdrawal of exemptions from the deferred or non-monetary payment of the variable remuneration; and
- excessive expectations towards small institutions.

In the consultation, the MNB essentially supported the interpretation and proposals offered by the Banking Association, and declared that it did not require specific reporting of individual incomes of managers. Additionally, on a temporary basis, pending the entry into force of the relevant EBA Recommendation in early April 2017 and the amendment of CRD IV as proposed by the EBA, the MNB accepted our proposals concerning the application of the proportionality principle in line with the provisions of the government decree regulating the matter.

In late October, the methodology area of the MNB issued the Banking Association with its draft recommendation drawn up on the basis of the remuneration guideline of the European Banking Authority (EBA). In addition to the issues of interpretation discussed above, the draft recommendation raised further issues, including the fact that the MNB had restricted basic remuneration to base pay only, classifying under performance remuneration a number of fixed wage components that were unrelated to performance.

In early December, we held a personal consultation with the MNB on our proposals concerning the draft recommendation. As a result, the recommendation promulgated in early February offers the interpretation of proportionality that is required under the applicable government decree; does not impose a disclosure obligation at the level of individuals; by providing an exemplary list of wage components unrelated to performance, it removes them from the scope of deferral and non-financial payments; and becomes effective as of July 2017 as we requested.

Additional legislation and drafts

In addition to the foregoing, in 2016 the MNB issued *two decrees* and *one recommendation* on the *management of credit risk*. (The provisions of “MNB Decree on Customer and Counterparty Rating and on the Prudential Requirements of Collateral Valuation”, “MNB Decree on the Prudential Requirements Pertaining to Non-performing Exposures and Restructured Debts”, and “MNB Recommendation on the Measurement, Management and Control of Credit Risks” are applicable as of 1 January 2017.) The MNB also drafted a recommendation on the *application of general consumer protection principles* as well as *product oversight and governance arrangements for retail money market products*. The *MNB decree on risk-based fee payments to the National Deposit Insurance Fund of Hungary (OBA)* took effect on 31 May 2016. The expert working group comprising the representatives of the competent regulators (MNB, NGM), advocacy organisations (Association of Investment Service Providers, Hungarian Banking Association) and the work organisation commenced preparations for *risk-based fee payments to the Investor Protection Fund (Beva)*. *Act LIII of 2016 amending certain acts related to the financial intermediation system* amended the provisions of the MNB Act concerning the Financial Arbitration Board (PBT) to the effect that up to HUF 1 million, the PBT is authorised to adopt binding and enforceable decisions against service providers without any statement of submission by the latter. Within the meaning of another amendment adopted at the initiative of the Banking Association, a binding decision can be opposed, which will cause the procedure to be transformed into legal action.

Reporting

In the context of reporting for monetary and supervisory purposes, in 2016 the banking expert group established jointly with the MNB continued to develop the new reports aligned with IFRS transition. By summer 2016, the consultation was completed, and the reports were developed which from 2017 onwards, credit institutions will be required to submit to the MNB on a regular basis, irrespectively of whether they use IFRS or the national accounting standards. (From 2018 onwards, each Hungarian credit institution will be required to apply IFRS, whereas in 2017 both IFRS and national standards are used.) Due to IFRS implementation, there will be material changes in reporting in terms of both structure and content, and the central bank will require much more detailed information on credit and deposit products. The MNB considered that the consultation process commenced in 2015 was successful and that it was also beneficial to banks, given the fact that several proposals from the banking industry were incorporated into final reporting.

In 2016, the central bank also notified credit institutions that from 2018 it would request EBA ITS reports (COREP+FINREP) in XBRL format, and was already developing its IT system for data registration and processing accordingly. The objective is to improve the quality of statistical data and accelerate data transfer through the application of uniform standards and technologies. Arguing for the retention of the fully operational system currently in place, and objecting to the timing (on grounds of IFRS transition being mandatory from 2018), we initiated a consultation with the MNB with a view to changing its decision. As the MNB insists on XBRL transition, we proposed the launch of a joint project to support preparations for the transition to XBRL, which is not widely used and is therefore mostly unknown in Hungary. The MNB considers the six-month extension and progressive implementation to be manageable, and is also open to a consultation on details next year.

VII. Payment Services

Implementation of the PAD³

The deadline for the national implementation of the Payment Accounts Directive in respect of basic payment accounts and bank account switching was mid-September 2016; however, the regulation, which requires significant preparation time and bank development, was only issued in late August. (In response to our urgent warning, the legislator postponed the implementation deadlines to the middle/end of October.) Following the promulgation of the government decrees, the Hungarian Banking Association arranged for several consultations for its members involving experts from the Ministry for National Economy, and requested positions on issues that remained open.

In the fields of basic payment accounts and bank switching, similarly to other Member States of the EU, the Banking Association had been self-regulatory for years. To avoid duplication, these measures were repealed by the Board of the Banking Association in alignment with the effective dates of the decrees.

The Directive was introduced differently for each topic:

- Banks were required to apply basic payment account legislation as of mid-October 2016, which due to the short preparation time required strained work; however, following implementation relatively few issues arose that impeded application.
- The time to prepare for the application of the bank account switching regulation as of end-October 2016, for reasons similar to the case of basic payment accounts, was again insufficient, and even after implementation many significant issues remained to be clarified. It was essential that the customer data and information transmitted between banks should be interpreted uniformly by all stakeholders. As far as implementation was concerned, it was decisive that GIRO Zrt. undertook to help interbank data flow, essential for bank switching, with standardised messages. A working group consisting of the experts of banks and of GIRO elaborated the basic form to be used for bank switching, i.e. the Authorisation for Bank Switching to be completed by each customer requesting switching, as well as the other statutory documents serving communication between the bank and the customer. These features were highly instrumental in making the process of bank switching more organised.
- Comments on the EBA guidance that is to constitute the basis for regulations on the comparability of fees related to payment accounts had to be made by December 2016; however, its implementation is likely to be postponed until end-2017. The Banking Association's Payment Accounts Working Group analysed the EU proposal in several meetings, and submitted the opinion emerging to the EBA, highlighting the importance of national latitude to support usability.

Preparations for the implementation of PSD2

In January 2016, the EU issued PSD2⁴, which Member States are required to apply as of January 2018 at the latest.

While a key feature in the former Directive (PSD1) was to incorporate payment institutions into legislation (to ensure that banks face real competition in payments), PSD2 incorporates so-called TPPs⁵ to ensure that banks face competition in e-commerce and to enforce their more pronounced integration into the digital world.

³Payment Accounts Directive

⁴ The new Payment Services Directive

⁵ Third Party Provider

TPPs are interposed between the account servicing bank, the e-merchant and the customer to accelerate purchase and payment processes; however, as part of that they may also access one of the most sensitive elements in the relationship of the bank and the customer: the identifiers that ensure authenticity. The Directive does not provide a solution to this issue, which carries the risk of abuse; the elaboration of the details is the task of the European Banking Authority.

In 2016, the EBA first circulated a consultation paper to seek EU stakeholders' opinions on ways to address the issue, then after processing the answers received, it published its draft standards setting out proposed solutions. (This essentially concerned strict – three-factor – customer authentication, and the standards of communication between banks and the TPP.)

The first EBA consultation paper was processed in the Payment Services Working Group, supported by the summary material provided by the European Banking Federation. We analysed the draft setting out the EBA standards as part of an extensive consultation with the MNB, with contributions from experts in the working groups concerned. In its opinion sent to the EBA, the Banking Association highlighted the following:

- In the course of the licensing procedure, the supervisory authorities should not only examine statutory compliance, but entities applying for the TPP licence should also be subjected to runtime tests (executed by accredited expert companies) to prove that TPPs may not access the data managed by them.
- Strong customer authentication (SCA) is an important achievement of PSD2; however, as these identifiers are handed over to the TPPs in the course of e-commerce, exceptions from the use of SCA will be appreciated. Banks would rather leave it to the customers that which TPPs and up to what amount they will allow to access their accounts.
- In the scope of preparation for security requirements it would also be necessary to make sure that the API⁶ necessary for the TPPs to access the banks' account servicing systems should be uniform.

The Payment Services Working Group set up a Task Force to process PSD2 in detail, as part of which it is responsible to provide bank experts with a comprehensive evaluation on the key features of the Directive and on any disputed issues arising, and to put forward a proposal to transposing national authorities for preferred solutions. In 2016, this Task Force held a number of meetings, and will produce a written report in 2017.

In late 2016, the Banking Association hosted a workshop with presentations by international professionals and domestic fin-tech companies on the opportunities opened up by PSD2 for TPPs and banks. To support banks' preparations, the Banking Association is planning to host additional workshops, involving potential competitors and cooperating partners.

The implementation of PSD2 was also addressed by the Board of the Banking Association: it approved the work previously carried out, while it also highlighted the importance of informing and preparing banks' partners and customers.

Managing utility provider switches for direct debit purposes

The Government appointed new, mostly state-owned enterprises for the supply of universal gas, electricity and waste services. As a significant part of the charges for such services had previously been paid via direct debit (DD), it was crucial to avoid forcing millions of provider/bank customers to adjust their DD orders with their banks individually.

The Banking Association made an active contribution to providing the legal background for transferring DD mandates without customers' involvement, and to arrangements for the flow of customer data between banks as required for the transfers. With a view to finding a solution, the

⁶ Application Programming Interface

Banking Association held detailed consultations with service providers and their account servicing banks, and based on those consultations it developed a detailed schedule that specified the changes, the persons responsible, deadlines and interbank message formats, and also enabled testing, which it sent to all member banks concerned. The consultations were supervised by the Payment Services Working Group on a continuous basis, and involved its experts.

Based on the schedules developed, during the year the E.ON–FŐGÁZ, TIGÁZ–FŐGÁZ, and ELMŰ/ÉMÁSZ switches were completed smoothly, including the payment background to those switches. Problems only occurred with the waste service as a result of insufficiently defined regulatory and organisational changes.

Bankcard statistics, recent developments, Bankcard Working Group

○ Bankcard statistics

According to MNB data, in 2016 Q1–Q3 the volume of e-payments continued to grow steadily, including primarily a substantial increase in the volume of payment card transactions. The rapid spread of contactless payment technology is due in part to the steady growth in the share of contactless cards (the number of payment cards issued in Hungary passed the 9 million mark, more than 60% of which is contactless-enabled), while as a result of continual improvements on terminals, approximately three-quarters of the devices in Hungary became NFC⁷-enabled. As a combined result of the two effects, from 2016 H2 onwards reports clearly showed that a stable majority of payment card purchases were contactless payments. In addition to the development of infrastructure, the volume of domestic payment card purchases continues to grow dynamically. Transactions administered in the Hungarian acceptance network with cards issued in Hungary totalled HUF 869 billion, corresponding to a 23% increase in annual terms. The average value of contactless payments is still significantly lower than that of traditional transactions (HUF 4,769 and HUF 9,034, respectively), which means that the spread of the new technology has primarily enabled the replacement of an increasing number of cash transactions of low value.

○ Implementation of MIF EU regulations

Adopted by the European Parliament and the Council in April 2015, Regulation (EU) 2015/751 imposed a number of administrative duties on the European banking sector in addition to the regulation of interchange fees. The provisions set out in the regulation, to be applied by 9 June 2016 at the latest, require extensive preparations from both issuing banks and acquirers.

We held a series of consultations on the practice to be followed with card companies and plastic manufacturers both nationally and regionally. In formulating its expectations for the implementation of the regulations, the MNB gave consideration to our professional arguments on a number of points.

In order to inform merchants and consumers, an obligation was imposed on issuers to indicate the type (credit/debit/prepaid/commercial) of each card on the card both visually and electronically. Ensuring electronic identification on previously issued cards in circulation presented a major technical challenge, as it would have required the full replacement of the approximately 9 million cards in circulation. Relying on international information from the EPC⁸, we confirmed that in international professional practice, the use of BIN tables qualifies as acceptable over the short term.

⁷ Near field communication

⁸ European Payments Council

- *MNB consultations*

In the context of the Hungarian launch of MasterCard's Instalments, an instalment service linked to credit/debit cards, we initiated comprehensive prior consultations with the MNB's Consumer Protection Directorate. In his letter following the consultation, the Deputy Governor of the MNB referred to the professional consultation prior to the launch as extremely forward-looking. We also held regulatory discussions on MasterCard's MoneySend service, and the appropriate and required application of a card blocking fee.

- *Professional consultations and talks*

In spring, senior officials of the Bankcard Working Group gave a series of talks at the members' meeting of the Hungarian Vending Association (MIÁSZ) titled "Cashless Solution in the Vending Industry". We gave participants a rundown on general information on and conditions for enabling bankcard payment.

With contributions from NGM presenters, on 7 September we hosted a workshop on the latest regulatory developments concerning business cards, providing an overview of possibilities to encourage business card use on a larger scale.

In the kick-off workshop held in the context of preparations for PSD2 with contributions from Hungarian and international presenters and the MNB, representatives of the bankcard area were also informed about expected changes.

Starting from the second half of October, we participated in the professional consultations arranged and lead by the Ministry for National Economy in connection with the preparation of the payment blockage of prohibited gambling transactions.

As part of professional cooperation, during the year members of the Bankcard Working Group were given opportunities for free attendance in a variety of international conferences.

- *Fraud*

According to the MNB's reports, the ratio of bankcard fraud to the total volume of purchases remains below 0.01% in terms of the number of transactions and 0.04% in terms of their value, which is outstandingly good even by European standards. A 79% majority of fraud incidents continue to be associated with CNP⁹ transactions, which do not require a card to be present, primarily affecting cross-border transactions.

As in previous years, in mid-May we hosted the Fraud Professional Day, which focused on ATM raids and solutions to provide effective protection. On this occasion, in addition to the experts of EUROPOL from the Hague and those of the National Investigation Office from Budapest, technological service providers also shared their knowledge in the interest of operating an incident-free ATM network.

In the last week of October, we joined the international anti-cybercrime campaign of EUROPOL. As part of this, we called attention to the different potential threats and fraud types that may be facilitated via electronic channels, with particular focus on the mobile environment. Some "innovator" banks introduced geo-blocking in their Hungarian practice of bankcard fraud prevention. The solution involves the geographic restriction of the cards in circulation based on usage habits, and has significantly reduced fraud damage in a number of regions across Europe.

In cooperation with the International Training Centre of the Interior Ministry, we continued to set up and offer training in the Cyber Crime Cabinet and Lab. We also continued preparations for the OF2CEN international programme, which we hope will provide an efficient platform for prevention in the future.

⁹ Card Not Present

Developments on banknote replacement

Second in the series of new banknotes and following the HUF 10,000 note, the HUF 20,000 note entered into circulation in December 2015, and in 2016 the old notes were gradually withdrawn and replaced with new ones without any disruptions. However, the schedule of withdrawal sparked off a professional debate at the beginning of the year. The majority of bank experts argued for progressive replacement that also allowed recirculation, and the most distant possible date of withdrawal (2016 year-end), which was also justified by the significant demand for cash in payments. The central bank decided to accept banks' arguments for a withdrawal deadline at the end of the year, but introduced a recirculation ban on the old HUF 20,000 note as of May 2016 for all operators in the cash market.

In this context banks also were taken by surprise when the central bank, shortly before the end of the year, announced that the withdrawal of HUF 20,000 notes would be postponed for one year. In order to analyse the new situation, the Cash Working Group held an extraordinary meeting, to which the management of the Cash Logistics area of the MNB was also invited. In the consultation, the representatives of the central bank advised that although it could be regarded as a success that in a matter of one year the share of new HUF 20,000 banknotes had increased to 80%, the volume of old HUF 20,000 banknotes that remained in circulation was still significant, and it was a priority that this stock should be withdrawn gradually, at a natural pace.

Accordingly, banks can continue to exchange old HUF 20,000 banknotes into new ones at the central bank free of charge, and the prohibition of recirculation also remains effective. Members of the Working Group took note of the central bank's position; indicating, however, that in specific cases they might not carry out the exchange for customers of old HUF 20,000 banknotes into new ones automatically and free of charge, as the replacement of large amounts may upset the cash management of the given branch.

SEPA End Date Regulation: preparations and implementation

In a proactive manner and giving due consideration to the weight of the Regulation, experts of the SEPA Working Group and the Payment Services Working Group started preparations for compliance with euro payment requirements as early as in autumn 2015, as a result of which all of our member banks completed their migration to the common rules and standards by 31 October 2016. In addition to cooperation between the working groups and the commencement of preparations in due course, successful migration was also enabled by the Banking Association's plan for professional and communication support. As part of the plan, we addressed the set of requirements contained in the Regulation in terms of both principles and practice, and published an *Information Brochure* on the results. We developed the communication components of the preparation process, including questionnaire follow-up on the process, and adequate awareness raising and information for the public at large and companies. We published articles in the electronic media and the printed press, which aimed to increase SEPA awareness, while supporting companies in their preparations for handling bundled orders. We also explained the changes and facilitations that affected retail customers. In the development of our plan to support preparations, including the questionnaires following up the preparation process, we gave consideration to the MNB's requests that promoted ECB reporting. As part of preparations, some payment service providers relied on support from the Banking Association's NASO¹⁰ in their adherence to one of the payment schemes (mostly credit transfer) operated by the EPC.

Other key developments concerning the EPC and SEPA

Following rearrangements in its organisation and governance in 2014, the European Payments Council (EPC) closed its first two-year cycle in 2016. The rearranged organisation performs its

¹⁰ National Adherence Support Organisation

activities in two modules: the first module includes activities addressing the operation and maintenance of existing payment schemes, the assessment and collection of any customer needs arising, the management of complaints, and the settlement of disputes between users. This module is managed by an independent body called *Scheme Management Board*. The working groups of the other module deal with innovations associated with various payment methods. As part of its activities, the second module is engaged in specific development tasks initiated by the first module as well as by external organisations, notably the ERPB¹¹ and the ECSG¹². The EPC itself is a member in both organisations. The EPC received the most prominent request from the ERPB back in 2015, for the development, by the end of 2016, of the *SCT Instant Credit Transfer Scheme (SCT Inst)* based on the SEPA credit transfer scheme that had been operational since 2008.

By virtue of the SEPA End Date Regulation, the past year has been extremely important for the establishment of the Single Euro Payments Area, as non-euro area Member States also had to complete their migration to the common pan-European rules and standards as regards their euro payments (credit transfers and direct debits). This standardisation process was somewhat counteracted by the fact that several member states independently set up *instant payment systems* in respect of their domestic currencies and payments. For example, United Kingdom, Denmark, Poland and Hungary also started developments in this direction. In the eyes of European regulators, these initiatives by Member States may jeopardise the development of the SEPA as they might result in the fragmentation of the payments market, therefore, under ERPB supervision, and through the involvement of the EPC and the use of the SEPA credit transfer scheme, regulators encouraged the design and earliest possible deployment of a uniform euro based instant payment scheme. Based on the SEPA credit transfer scheme, by November 2016 the EPC elaborated its *SCT Instant scheme*, which, unlike the credit transfer and direct debit schemes, is optional. The scheme, which will be accessible in 34 states (28 EU Member States plus Iceland, Norway, Lichtenstein, Switzerland, Monaco and San Marino), will also be open to participating payment service providers as payees only. The scheme offers simple adherence for service providers that are members of the credit transfer scheme. At the level of individual transactions, the scheme will enable the transfer of EUR 15,000 *within ten seconds* between the payment accounts of the payer and the payee. These initial parameters are not set in stone either; members of the scheme may bilaterally or even multilaterally agree on higher amounts and shorter execution times. The ten-second execution time is the time within which the amount in question will be credited to the payee's account, and the payee's bank notifies the payer's bank that it has made the amount available to the payee or that it rejects the transaction. The service providers adhering to the scheme must be technically able to process instant credit transfers at any time of the day and on each day of the week throughout the year, irrespective of non-business days and holidays. Operational from 21 November 2017, the SCT Instant payment scheme will be open to adherence for payment service providers via NASOs, as with the other payment schemes.

In addition to the foregoing, the EPC working groups addressed standardisation issues concerning card payments, the new Payment Services Directive (PSD2), the payment services and service providers named in the Directive, with particular emphasis on the related EBA RTS¹³, the requirements for the customer authentication method set out therein, and the security requirements for transactions between payment service providers.

In its strategic meeting in October, the EPC Board committed itself to the concept of EPC+, which means that the organisation wishes to participate in the digital transformation and development of European payment services in a proactive and foreseeing manner.

¹¹ Euro Retail Payments Board

¹² European Card Stakeholder Group

¹³ Regulatory Technical Standard

Preparations for the implementation of an instant payment system in Hungary

A new phase in the development of payments is marked by the central bank's concept created by the name of *"Dimension shift in payments – Possibilities for the implementation of an instant payment service in Hungary"*, which was submitted for professional consultation following approval by the Financial Stability Board (FSB). The MNB invited the Banking Association to engage its members actively in efforts to create an instant payment system, and primarily in arrangements for the professional central bank forums and consultations as part of which the scheme would be designed and implemented. Accordingly, the banks participated in the forums hosted by the MNB, and the competent working groups of the Banking Association consulted the central bank's experts. The MNB also put its questions on the concept to the banks in writing, and held bilateral consultations on the initial scheme to be implemented. The FSB adopted its decision on the operational scheme by taking into account banks' opinions. As part of the instant payment system, through state-of-the-art IT and communication solutions it will become possible to carry out credit transfers in a matter of seconds on any day of the year, around the clock, up to HUF 10 million in a wide range of payment situations. Within five seconds of sending, the amount in question will be credited to the payee's payment account, and will be at the payee's free disposal. Apart from the use of account numbers, it will also be possible to initiate transactions based on secondary account identifiers only (the payee's telephone number and e-mail address).

Coordinated by the MNB, a project is set to be launched in 2017 for the *modernisation of the nationwide financial infrastructure*, as part of which all stakeholders must carry out the required developments so that the instant payment service becomes available to users in 2019 H2 at the latest.

Takeover of tasks from the SWIFT National UMG¹⁴ and other SWIFT events

Following the takeover of SEPA-related tasks in 2014, in summer 2016 another task was added to the Banking Association's payments-related activities: at the request of the SWIFT National User and Member Group, going forward the Banking Association will be in charge of the governance, organisation and notification tasks related to the UMG, and of the tasks associated with representation and communication within the SWIFT organisation. In general, the Banking Association's working group established pursuant to the decision convenes twice a year to present SWIFT's new services, applicable message standards and tools, to review the training opportunities related to new features, and to share information on SWIFT's secure and reliable operations. Presentations by the SWIFT country manager focused on the regulatory changes affecting SWIFT operations, and their incorporation into daily operations.

In 2016, the SIBOS¹⁵ was held in Geneva with the title *"Transforming the Landscape"*. Addressing essentially four aspects of the major changes implied by its title, the seminar discussed the challenges presented by *digital transformation*, various *innovations* and *financial crime* (cybercrime), and the extremely powerful effects of those challenges on competition, which actors in the "official" world of finance must respond to. The four aspects were banking services, regulatory compliance, the culture of banking services, and the field of securities, which provided the main theme of one day each. Apart from such innovations as blockchain and its integrated distributed ledger technology, the spread of instant payment systems, the effect of mobile telephony replacing the system of banks (branches) in extensive areas where no alternative infrastructure is available, the *prevention and management of cybercrime* was the most prominent of the four themes. SWIFT developed and

¹⁴ User and Member Group

¹⁵ Swift International Banking Operations Seminar, the most prominent global event hosted annually by SWIFT

announced its CSP¹⁶, and SWIFT's CEO and Head of Security called on all members and users to implement the programme.

VIII. Taxation, accounting

Changes in tax regulations affecting credit institutions

Changes in 2016 to several aspects of the *regulation on the bank levy (Act LIX of 2006)* are of the essence for credit institutions: the credit institutions' allowance was discontinued; the rate of the bank levy was revised (0.21% above an adjusted balance sheet total of HUF 50 billion in 2017 and 2018, remaining at 0.15% below HUF 50 billion); the base of the levy is no longer tied to the 2009 balance sheet total but is, from 2017 onwards, derived from the figures of the second fiscal year preceding the fiscal year concerned. As a special rule, in addition to the *levy on investment services*, a new *levy* was introduced *on financial leases*. The two levies are not particularly compatible with the levy based on the balance sheet total, and there is a great deal of uncertainty about their application. In connection with the lease levy, one problem arises from the calculation of the result of leases, given that in credit institutions (unlike in financial institutions), leased assets cannot be directly linked to the underlying liabilities, because in banks, liabilities could include a variety of deposits, borrowings or issued securities, and there are also several possible allocation methods to determine expenditures. Another question is raised by the practical implementation of the legal provision concerning the method using which the lease levy can be taken into account for the purposes of the bank levy. The base of the levy on investment services cannot be derived precisely, because the legal provision refers to the accounting decree for investment firms (rather than specifically for credit institutions).

In 2016, *adjustments were being made to tax regulations related to the IFRS transition*, concerning primarily the rules of corporate tax and local business tax liabilities. The Banking Association's Tax Working Group held several consultations, and put forward detailed proposals with analyses on their effects to clarify the rules and improve their applicability. We proposed that tax assessment should be based on FINREP profit and loss accounts according to the IFRS that are based on individual (unconsolidated) data, are continuously controlled by the MNB, and are standardised for the sector; however, our proposal was not supported by regulators. Instead they refined the act that has already been promulgated but has not yet taken effect. For institutions transitioning to IFRS, one requirement relevant to taxation is that where an institution files an application for conditional tax assessment, going forward it will be required to enclose to its application an expert opinion from the Chamber of Hungarian Auditors on the rating of accounting treatments.

Another important change promulgated at the end of the year is that for 2017 the corporate tax rate will be reduced uniformly to 9% from the previous dual rates (10% up to a base of HUF 500 million, and 19% above that threshold in 2016). Additionally, the rate of the social contribution tax will be reduced from 27% to 22% for 2017, and by an additional 2 pps to 20% for 2018. The upper rate of the health contribution, charged on other types of income, will also be reduced from 27% to 22%.

For customers' benefit, with long-term investment agreements taxed at a preferential rate, from 2017 onwards, at the Banking Association's initiative, following the expiry of the 5-year preferential commitment period, individuals will have the choice of recommitting either the full amount of their matured savings, or only a part, taxed at preferential rate, with the possibility to make a non-taxable withdrawal on the remaining part.

As of 2017, the 6% health contribution (EHO) on interest income will be cancelled.

¹⁶ Customer Security Programme

A change affecting savings held in securities is that going forward, controlled capital market transactions, which are also taxed at a preferential rate, need to be reported to the tax authority earlier and in significantly greater detail by credit institutions and investment firms managing such products. Reporting is already due in early 2017 and also covers securities flows in 2016.

Legislative changes have also been made concerning the mandatory exchange of tax data between tax authorities CRS/DAC2), in response to the proposed specifications emerging in practice, and to the domestic adoption of EU DAC3. The practice followed within the Community and among states endorsing the EU SD¹⁷ was repealed due to the EU CRS/DAC rules taking effect. Consequently, with customers previously classified in this category, from 1 September 2016 onwards domestic paying agents must essentially apply the rule under the double taxation conventions in respect of interest income, which requires the development of new procedures in credit institutions.

In 2016, the Banking Association's Tax Working Group continued to play an active role in initiating legislative changes and in commenting on drafts, and negotiated with the competent regulators on several occasions. We consider it an achievement that the rule on tax refunds related to *the Settlement Act*¹⁸ could be specified in accordance with the calculations approved by the MNB and the practice followed.

Developments on IFRS transition

National requirements for mandatory IFRS transition continued to be refined also in respect of accounting rules. For credit institutions and financial institutions subject to equivalent prudential regulation, the date of mandatory IFRS transition in respect of individual accounts was postponed from 1 January 2017 to 1 January 2018, nevertheless allowing early implementation as of 1 January 2017 at institutions' own discretion.

Early transition requires the institution to have its preparedness certified by an auditor, and submit the certification report to the MNB and the National Tax and Customs Administration at least 90 days prior to the transition date. The auditor must verify whether the credit institution employs an IFRS-certified professional, has developed an accounting policy in compliance with IFRS, and can provide comparable data according to IFRS 1 for the business year preceding the first year of transition. The decision is influenced by the fact that within IFRS, the IAS 39 standard on financial instruments is set to be superseded as of 2018 by IFRS 9, which represents a new approach. According to advisor opinion, however, it is not recommended to postpone transition to 2018 solely on the grounds of IFRS 9.

At the end of 2016, the Parliament passed another legislative amendment providing that credit institutions that had registered with the MNB and the NAV on or before 30 September 2016 might, by 15 December 2016 at the latest, withdraw their registrations concerning optional IFRS transition for 2017.

The postponement of mandatory transition for one year was a relief to some institutions, while others remained committed to implementation in 2017. The MNB has advised that out of the 120 credit institutions compiling individual financial accounts (including companies limited by shares, branches of international bank groups and cooperative credit institutions), 14 have transitioned from the national accounting system to the IFRS methodology as of 2017.

IFRS transition represents a comprehensive change for banking operations as a whole: apart from accounting compliance, it also requires institutions to take into account aspects of taxation and of regular central bank reporting. To *support transition*, in spring 2016 the Banking Association *hosted a professional meeting* for member banks' accounting, taxation and reporting experts, with

¹⁷ EU Savings Directive

¹⁸ Act XL of 2014 on the Rules of Settlement Provided for in Act XXXVIII of 2014 on the Resolution of Questions Relating to the Uniformity Decision of the Curia Regarding Consumer Loan Agreements of Financial Institutions and on Other Related Provisions

contribution from the advisers of PricewaterhouseCoopers. Representatives of the MNB's regulatory, supervisory and statistical areas were also invited to the consultation.

Effective as of 2017, amendments were also made to *Government Decree No. 250/2000 on the bookkeeping obligations of credit institutions* for the purpose of alignment with legislative changes associated with IFRS transition during the year, and with the rules set out in *MNB Decree No. 39/2016 on non-performing exposures and restructured receivables*, issued in the context of prudential requirements. The new MNB Decree is based on the Single European Rulebook-. Pursuant to the MNB Decree, as of 2017 credit institutions (whether they follow Hungarian accounting standards or IFRS) will not be required to apply the former five categories (performing, specific attention, below average, dubious, bad) for the purposes of rating receivables/credit granted, and the associated impairment ratios have also been discontinued.

IX. Developments concerning the Banking Association

2016 Assembly Meeting

The Hungarian Banking Association's regular annual Assembly Meeting was held on 8 April 2016. Minister for National Economy Mihály Varga attended and addressed the professional opening of the Meeting, where the deputy governors of the MNB were also present. In compliance with legal requirements, the customary reports and plans on financial management and the budget were complemented by a report presented by the Chair of the Supervisory Board. For the first time in 2016 but with the intention to start a tradition, the Assembly also resolved to issue a communiqué to state the Banking Association's position. Issued for the press and the general public, the communiqué pointed out in particular the key importance of restoring confidence in the financial system in the post-crisis period. It recapped on the fact that the effective revenues of the sector have been shrinking steadily, while the tax burden on the sector is outstandingly high. As a combined result of these factors, the profitability of the banks operating in Hungary falls short of the internationally required minimum. Leaders of the Hungarian banking sector are confident about the balanced development of the Hungarian economy, which they can support through even more active participation in an adequate regulatory and social environment. The communiqué provided an outlook on the events concerning European banks, including the changes in financial markets and uniform regulations that create a new competitive situation.

For the fifth time, the 2016 Assembly Meeting presented the Hungarian Banking Association's traditional Golden Beehive Award to member banks' employees who had made a significant contribution to the operation and development of the banking sector. In 2016, the Hungarian Banking Association's Golden Beehive Award was presented to:

Dr. József Baki (FHB Bank) – application of data protection and bank secret regulations;

Dr. Bálint Csere (OTP Bank) – arrangements for credit institutions' compliance in terms of settlement and personal bankruptcy;

Zoltán Horváth-Szladek (Erste Bank) – support for the development of the Personal Bankruptcy Act and its implementing decrees;

Gabriella Kárpáti (Eximbank) – professional supervision of the EXIM Working Group;

Péter Tódor (Budapest Bank) – practical preparations for the HUF conversion of loans;

Dr. Vanda Toma (CIB Bank) – practical implementation of settlement legislation;

for their outstanding work in the fields indicated.

Money Week (Pénz7): Summary on the implementation of the 2016 project week, preparations for 2017

We conducted surveys to collect feedback from participants in the Money Week series of events in spring 2016. Delivered to 100,000 students in 788 schools with contributions from 1,000 teachers and support from 200 bank volunteers, the programme was shown to be outstandingly successful by survey results (98% average satisfaction, 95% of respondents found the selection of themes to be excellent or good, and satisfaction with organisation was above 90%). Even in their own judgement, teachers and volunteering financial experts gave excellent cooperation to make financial knowledge tangible and comprehensible for students. Building on positive feedback and incorporating the lessons learned, in summer 2016, following Board approval, we started preparations for the 2017 Money Week as the Hungarian participant of the European Money Week project.

As the industry partners cooperating on the project (Money Compass Foundation/MNB, Ministry of Human Resources, Junior Achievement Hungary) also considered the programme as successful, preparations were started jointly. Integrating the programme in the national curriculum, the Ministry of Human Resources announced the event for 6–10 march 2017 under the title “Week of financial awareness and management”.

For 2017, the syllabus was enhanced to include business development, therefore, the Ministry for National Economy was engaged as a co-organiser, while Minister Mihály Varga also volunteered as a speaker in the programme.

Member institutions of the Hungarian Banking Association contribute to the Money Week series with hundreds of volunteering financial experts, and a number of fun features to strengthen the programme’s appeal. The programme is sponsored on behalf of the Management Board by Board Member Éva Hegedüs.

Hungarian Competition Authority (GVH) procedure on BankAdat

In the Hungarian Competition Authority’s procedure opened in April 2012 on the assumption of unlawful agreement in connection with the BankAdat database, in the first days of 2016 the Competition Council adopted a decision directly condemning the Hungarian Banking Association and the International Training Centre for Bankers. The decision obliged the Hungarian Banking Association to pay a penalty of HUF 4 billion in 20 equal monthly instalments. The decision also named the participant banks in the database, and indicated its intention to issue a specific order to oblige, on a joint and several basis, the named banks to pay any penalty that has not been paid and cannot be collected.

The Banking Association submitted an application to the Budapest Court of Public Administration and Labour, requesting a review of the decision and suspension of the enforcement of the penalty. The court validly dismissed the request to suspend enforcement of the penalty. The banks named in the procedure also filed their counterclaims against the decree of the Competition Council. The court joined the applications under a single case number to hear the case in a single procedure. Originally scheduled for September, the review procedure eventually commenced in early December at the Budapest Court of Public Administration and Labour.

Communication statistics and current issues

While 2016 remained an active period in terms of communication and provided plenty of issues, the outstandingly intense press interest of the previous years subsided to the average level. According to our statistics, we were covered in online media on 1,971 occasions, followed by print coverage (690), then coverage in electronic media, in approximately 530 cases. During the year, the Hungarian Banking Association was featured and mentioned in Hungarian media on a total of 3,200 occasions, explaining the professional positions of the sector to the press and the general public.

The condemning decision of the Competition Council on BankAdat remained a prominent theme in banking communication throughout the year. Regarding the penalty imposed, the Banking Association issued two press releases to underline that although it would honour its obligations arising from the decision, it considered the decision and the penalty unacceptable, and it would seek remedies nationally and internationally. The conditions of the housing subsidies for families (CSOK) also attracted continuous and extensive media coverage. In its communication, the Banking Association paid particular attention to the Money Week (Pénz7) programme series, which attracted an increasing audience and interest. In addition to the opening event which received media attention, we reported on the programme by means of two press releases and plenty of other coverage.

Following the Assembly Meeting, we compiled the positions of the sector in a communiqué.

We informed the general public about the most prominent current issues through the publication of press material. Our main themes were the effect of Brexit on the banking sector, a position on the FGS increase, the instrument of personal bankruptcy, improvements on SME lending, repeated efforts to contact mortgage debtors in default, the regulation and practice of the basic payment account, and the incorporation of reduced real estate agency commissions. Looking ahead, we addressed the directions of development for the banking sector, and the apparent and likely effects of digital transformation. Additionally, we communicated information on SEPA requirements concerning corporate customers, issued a secretary general's statement on the bank robbery in Oktogon tér, and published several guidelines on bank and card security. In December, the annual closing interview by the President gave a round-up on the Hungarian Banking Association's activities, and provided an outlook for 2017.

International relations – V6 meetings, agreement on cooperation with China

Held in the spirit of regional cooperation, the semi-annual meeting of V6 banking associations was hosted by Slovenia on 2 to 3 June. The country-specific overview of the post-crisis banking and economic processes featured prominently in the consultation. As another subject of particular interest, participants discussed the deposit guarantee funds and resolution regimes in each country, the characteristics of the instrument of personal bankruptcy, and the consequences of an environment of low interest rates.

The V6 autumn meeting was hosted by Hungary. The meeting was attended by the operational heads of the banking associations of Croatia, the Czech Republic, Slovakia, Slovenia, Poland and Hungary. Participants in the Budapest meeting confirmed that in general, the macroeconomic environment had become more favourable in all countries across the region, and that the performance of the banking sectors had improved. The agenda included regulatory issues and local implementation, as well as issues relating to the financing of the economy with particular regard to SMEs, the Payment Accounts Directive, the amended Payment Services Directive, competition authority proceedings, remuneration and the implementation of IFRS 9.

As a key milestone in the development of the financial relations between China and Hungary, the Hungarian Banking Association was the only representative of the European Union to receive an invitation to the Boao Forum, a leading economic and financial conference hosted annually by China since 2001. At the event staged on 23–24 March 2016, representing the Hungarian banking sector as an invited contributor to the Financial Leaders Roundtable, Secretary General Levente Kovács signed a memorandum of understanding on preparations for the establishment of AFCA¹⁹. AFCA is intended as one of the most prominent financial associations in the Asian region, which could offer, by means of the network developed at the launch of the organisation, a number of cooperation opportunities for the benefit of Hungary's banking system and economy, either in terms of information concerning

¹⁹ Asian Financial Cooperation Association

the financial institutions sector, strengthened interbank relations, or the exchange of research results on finance. Objectives include the establishment of an international platform for cooperation on finance, which would be open for financial leaders and institutions from Asia and Europe based on the recommendation or invitation of founding members.

As part of the Forum, a cooperation agreement was also signed between the Chinese Banking Association and the Hungarian Banking Association. The agreement enables member banks of the two associations to establish relations to support the efficient implementation joint investment programmes in the two countries, offering opportunities to strengthen their economic, financial and commercial relations.

Working committees and working groups not mentioned in the foregoing

○ Data Protection Committee

At the meetings of the Data Protection Committee, we addressed the data protection implications of the legislative concept on debt collection developed under the coordination of the MNB, listened to a presentation of the data protection aspects of debt collection, the investigations of the National Authority for Data Protection and Freedom of Information (NAIH) on the subject, and organised a joint talk on electronic personal documents with contributions from other working groups and outside experts. The agenda included some issues relating to the Privacy Act that required interpretation, preparations for electronic communications with courts, and the NAIH recommendation on data protection requirements for prior customer notification, data controlling based on legitimate interests, and the practice of applying the interest assessment test. The Committee monitored the adoption of the new data protection regulation of the EU.

NAIH Chairman Attila Péterfalvi was our guest in June. The discussion concerned the implementation of the NAIH recommendation on data protection requirements for prior customer notification, and preparations for legislative changes required as the new EU data protection regulation took effect.

Attila Péterfalvi proposed that on the basis of legal regulations for the sector and the specificities of the banking business, the Banking Association should develop a sector-level recommendation in connection with the NAIH recommendation on prior customer notification, which would be audited by the NAIH on request within the confines of the Privacy Act. Pursuant to Board of HBA approval, the Committee developed its recommendation, which is currently being audited. The recommendation was developed with a view to considering the industry-specific features of credit institutions in order to assist the overview of the system of credit institutions' data controlling information, and to provide a model for the adoption of good practice.

The Committee started preparations for the implementation of the new General Data Protection Regulation. (*Regulation (EU) 2016/679 of the European Parliament and of the Council on the protection of natural persons with regard to the processing of personal data and on the free movement of such data, and repealing Directive 95/46/EC, GDPR*).

○ Working Group on Agriculture

In 2016, the Working Group on Agriculture consulted the representatives of the Prime Minister's Office, the National Land Fund Management Organization, and the Agricultural and Rural Development Agency. Additionally, it held several consultations with representatives of the Public Warehouse Supervision and the Hungarian Warehousing Association.

In the consultations, the Working Group addressed the following key issues:

Development of a concept on the procedures for purchase and sale involving loan transactions relating to the sale of state-owned land to farmers as part of the "Land for Farmers" programme, consultation on the procedures to be followed by banks. As part of the programme, about 30,000 farmers purchased approximately HUF 270 billion worth of land at market prices.

The Working Group formulated its position on the *draft of a decree by the Ministry of Agriculture on the grant of temporary subsidies as part of Agro Széchenyi Card Schemes for certain agri-business sectors facing unfavorable market conditions*. To date, four financial institutions and the network of savings cooperatives have joined the Scheme.

The Working Group was advised about the changes relating to the *electronic submission of Standard Applications for agricultural subsidies*, about *adjustments to the terms of subsidies for agri-environmental management and disbursement procedures*, as well as about the main objectives of the *2014–2020 Rural Development Programme and Common Agricultural Policy*, and the changes of those objectives.

With a view to predictability in the flow of goods and payments, and to transparency and security in warehousing operations, the Working Group held consultations on *the main directions of modernisation in warehousing*, and on *lending secured by warehouse receipts*.

- *Compliance Working Committee*

In addition to the submission of proposed amendments to highlight the role of compliance in legislation, members of the Compliance Working Committee resolved in the autumn to develop guidelines for market operators by compiling best compliance practices in a single *self-regulatory document (Compliance Best Practice Code)*, also in view of the fact that the market customs emerging in recent years could not be incorporated into the MNB's updated recommendation on internal lines of defence.

The first draft of the Code has been completed and consists of four chapters, addressing respectively the key pillars of compliance awareness, the framework for the cooperation of areas in charge of control functions, the characteristics of conventional compliance functions and methods, and specific organisational features. All members contributed actively to the development of the draft either by compiling specific subchapters or by providing comprehensive comments on the material, ensuring that the Code effectively reflects the best market practice in Hungary.

Once we are familiar with the final contents, we will formulate a proposal on the status of the Code, i.e. whether it should be released as a recommendation requiring voluntary endorsement by member organisations, or as self-regulatory material proposing guidelines for member organisations.

- *EXIM Sub-working Group*

In 2016, the main activities of the EXIM Sub-working Group were the following. The Sub-working Group contributed to various product development and product documentation tasks related to the Credit Program for the improvement of competitiveness (implementation of working capital refinancing facilities, development of the final version of working capital refinancing product documentation, development of a facility agreement for refinancing individual investments). In 2016, through the involvement of partner credit institutions and based on Eximbank's refinancing plans a total of HUF 287.2 billion was granted in 1,515 items.

The Sub-working Group was advised about the concept on the *standardisation of the collateral guarantee scheme*, and about amendments to the *EXIM monitoring regulations* effective as of the last quarter.

- *Working Group on Mortgage Banks*

The Working Group on Mortgage Banks is responsible to identify and advocate the shared professional interests of mortgage credit institutions, and to promote the success of mortgage bonds in the capital market. The Working Group was set up in summer 2016 by transferring responsibilities from the Hungarian Mortgage Bank Association to the Hungarian Banking Association. The Working Group has retained the previous two-tier structure, in which the Main Committee is responsible for

strategic decisions, and professional (legal, appraisal, capital market) subcommittees for the detailed execution of specific topics and other professional work both nationally and at the level of the EU.

The Legal Subcommittee played an active role in the development of legislation and normative documents related to converted independent liens, as well as in preparations for the Covered Bonds (mortgage bonds) directive released by the European Commission for consultation. The work of the Appraisal Subcommittee focused on discussions about the experience with the statistical assessment of the Finance Ministry decree on the methodological principles of determining the mortgage lending value of property not qualifying as agricultural land. Reviewing international examples, the Capital Market Subcommittee developed plans to stimulate the mortgage bonds market, and assessed the legislative viability of those plans.

- *Legal Working Committee*

The Legal Working Committee actively participated in preparations for amendments to the Civil Code, and in expressing opinions on a number of minor legislative acts, such as the decree on the implementation of the Real Estate Registration Act. It joined other advocacy and sectoral organisations in the opposition to the concept of the Act on Attorneys concerning the status of legal counsels. Addressed to the Ministry for national Economy, it developed an extensive package of proposed legislative amendments concerning the sector.

Regarding the introduction of mandatory electronic communication with courts, to assist our members in the preparation, members of the ad hoc working group consulted the Electronic Procedures Department of the National Court Office and the E-Administration Department of the Ministry of Internal Affairs. Additionally, we arranged for bank experts' participation in the Law Association's open day on the issue, and saw experts from the Ministry of Internal Affairs and National IT Services Ltd., who provided information on the newly developed system to the Legal Working Group. We successfully ensured that interested bank experts could participate in the system testing.

The session of the *Working Group on Invalidity Action*, reviewed developments in judicial practice, specific Curia decisions, the lessons learned from the imposition of penalties in action for the termination of enforcement, and the interpretation of new provisions amending the Settlement Act.

- *Working Group on Training*

In October, we consulted the Ministry for National Economy on the requirements for bank experts' *applications for membership in examination boards* as part of the cash desk manager and foreign currency cash desk officer sub-qualification. We forwarded the requirements to member banks' experts.

At the request of the NGM, in early November we reviewed and completed the European Commission's *ESCO²⁰ list and its translation concerning the area of banking and finance*. The aim of the European Commission is to develop a multilingual classification at a European level to assist both Member States that do not have a classification system of their own and those where a nationwide and sectoral classification system is already in place, given the possibility to link and compare occupations between Member States at a European level via the single ESCO system.

²⁰ European Skills, Competences, Qualifications and Occupations, a project of the European Commission for the development of a single classification system for occupations at a European level

- *SME Working Group*

In 2016, the SME Working Group held several consultations with representatives of the National Bank of Hungary, the Prime Minister's Office, the Ministry for National Economy, KAVOSZ Zrt., and the Chamber of Hungarian Auditors.

In the consultations, the Working Group addressed the following key issues:

The Working Group was advised about available experience with the assessment of applications under the *2014–2020 Economic Development and Innovation Operational Programme (GINOP)*, and the application of the related *Development Policy New Database and Information System (FAIR)*. According to data as at 6 January 2017, approximately 4,000 positive grant decisions have been made amounting to more than HUF 1,300 billion.

The Working Group expressed its opinion on amendments to *Government Decree No. 272/2014 (XI. 5.) on the Rules of the Use of Funds from Certain European Union Funds*, and held several consultations in connection with *Act CXLI of 2015 on Public Procurement*.

The Working Group held consultations on *Stage 3 of the Funding for Growth Scheme (FGS)* and the *Market-Based Lending Scheme*. It developed a *model certificate* for the verification of the existence of natural foreign exchange collateral to secure EUR borrowings under the FGS.

Sessions of the Working Group also discussed observations on two plans (*Széchenyi Pre-financing Loan* and *Széchenyi Supplementary Loan*) under the *Széchenyi Card Scheme*. 80% of the credit institutions in Hungary are participating in the Scheme, granting credit in an annual volume of HUF 140-150 billion.

- *Working Group on Leasing*

In 2016, the Working Group on Leasing consulted with representatives of the Ministry for National Economy, the Ministry of Justice, BISZ Zrt., Eximbank and the Central Office for Administrative and Electronic Public Services.

In the consultations, the Working Group addressed the following key issues:

The Working Group developed its *proposal for amendments to Articles 69 and 72 of the Credit Institutions Act concerning the regulation of brokerage fees*, which will be considered as part of the next review of the Credit Institutions Act.

The Working Group expressed its opinion about the summary material on the control of HUF converted lease contracts in the Central Credit Information System, produced in connection with *Act CXLV of 2015 on the Settlement of Certain Issues Related to the Conversion of Claims Arising from Certain Consumer Loans to Forint*, and also discussed BISZ Zrt.'s position on *Article 11(1) of Act CXXII of 2011 on the Central Credit Information System*.

The Working Group commented on the *draft amendments to Act V of 2013 on the Civil Code*, and the proposed *amendments to the Collateral Register Act and certain related acts*.

For the standardisation of document office administration, it set up its Document Office Sub-working Group. The Sub-working Group developed a *model private deed* for the registration of lease customers' operator rights. As a result of consultations, information material was also compiled for document offices, and was made available to all document offices and government one-stop shops in December 2016.

- *Working Group on Macroeconomy*

In July, we put forward an initiative for widening the scope of the consultations between members on the state of play and expectations in macroeconomics by inviting and consulting the leading macroeconomists of the MNB and the NGM. The initiative was well received by the experts of the authorities, and supported arrangements for a semi-annual forum in agreement with members. The first expert meeting in the wider form was held in mid-September. Participants in the forum agreed that, notwithstanding the external and domestic risks reviewed, the short-term prospects of the

Hungarian economy were essentially positive, which was largely attributable to economic growth being increasingly driven by internal consumption apart from net exports.

- *L/C Working Group*

In 2016, the L/C Working Group held professional consultations with representatives of the Expert Body on Delivery Certification (TSZSZ) and the National Federation of Hungarian Building Contractors (ÉVOSZ) on the warranties and guarantees most commonly used in construction. The information guide produced as a result of the consultation explains the role of the TSZSZ in disputes concerning drawdowns on bank guarantees related to the delivery of contracts for architectural, technical design, building and construction works.

- *Working Group on Money Laundering*

Based on the new recommendations and methodology of the Financial Action Task Force (FATF), the Council of Europe Committee of Experts on the Evaluation of Anti-Money Laundering Measures and the Financing of Terrorism (MONEYVAL) started its 5th round of country evaluations in 2014, in which Hungary was listed third among the countries to be evaluated. The evaluation has been completed, but the contents of the detailed report have yet to be disclosed to market operators. The legislator is set to remedy the deficiencies and problems identified by means of the new anti-money laundering act.

Due to the departure of the former chair of the Working Group from the member institution, a new chair was elected in the summer. The Working Group elected MKB Bank Zrt.'s newly appointed Head of Compliance András Bácsfalvi as its chair.

In 2016 and 2017, the most important and most challenging tasks for the Working Group are to contribute actively to the implementation of the Fourth Anti-Money Laundering Directive (AML4), and to support provisions in the Anti-Money Laundering Act to set out solutions that are also acceptable by the market.

Cooperation on the implementation of AML4 with experts from the Ministry for National Economy is underway, as part of which representatives of the Working Group regularly consult the competent department of the NGM. In October 2016, the Working Group compiled comments that it proposes for consideration as part of legislative amendments due to the Hungarian implementation of AML4, and submitted those comments to the Ministry.

- *Treasury Working Group*

Pursuant to the Presidium's approval, in December we set up the Treasury Working Group. Before defining the responsibilities of the Working Group, we contacted the MNB's units in charge of regulatory issues concerning the capital market in order to align our work.

As one aim of the Working Group is to facilitate the implementation of new capital market regulations MiFIR/MiFID2), in mid-December we identified the issues that currently pose interpretation problems for banks.

At the MNB's request, in December we distributed to members the draft of the Code compiled at the initiative of the BIS in order to develop common regulations with a view to providing consistent foundations for the operations of the global foreign exchange market.

- *Work Out Working Group*

Experts of the Work Out Working Group participated in the work of the codification committee preparing amendments to the Judicial Enforcement Act.

In our meetings with the managers of the Bailiffs' Chamber, we also reviewed the issue of enforcement procedures restarting after the expiry of the enforcement moratorium, issues related to

bailiff notification after the settlement process and other experience related to the operations of bailiffs.

In early 2016, the Consumer Protection Directorate of the MNB initiated setting up an expert group to prepare a legislative concept on debt collection. The effort aimed to set out organisational and operational regulations on the collection of past due consumer debts by financial institutions (soft collection). In January, following multiple rounds of consultation with retail workout experts, we sent a detailed proposal to the MNB for the themes of the regulatory concept, and the expert group.

Due to other legislative tasks, the regulation of debt collection has been postponed.

INTERNATIONAL OUTLOOK REGULATION, SUPERVISION

Below we summarise the most important developments in prudential regulation that took place in 2016, covering global and European processes separately. Detailed descriptions of regulatory events can be found in the Annexes to our quarterly reports.

Global regulation

The set of goals and main directions of global regulation are determined at global level by the annual meeting of heads of states and governments from the G20 countries. The professional content and details are developed by the international bodies of global regulation. The Financial Stability Board (FSB) and the Basel Committee on Banking Supervision (BCBS) play a key role in the development of a consistent and effective global set of standards.

Financial Stability Board

The 2016 activity of the Financial Stability Board focused on the following key priorities:

1. Support to the full-fledged and consistent implementation of reforms decided in the wake of the crisis and the prevention of unintended material consequences;
2. Support to reliable financial infrastructures and establishment of the resolution framework for central counterparties (CCPs);
3. Management of new and emerging vulnerabilities in the financial system, including potential financial stability risks related to market-based financing, misconduct risk, a decrease in correspondent banking activity and climate change;
4. Examination and evaluation of the practical application of macro-prudential policy frameworks and tools;
5. Evaluation of the systemic consequences of financial technology innovations, and systemic risks arising from operational irregularities.

In 2016 the FSB primarily dealt with issues in finalising the regulation of *too-big-to-fail (TBTF)*, in order to promote **the fully-fledged, timely and consistent implementation of post-crisis reforms**. Thus it upgraded the *methodology for identifying G-SIBs*²¹, published in 2013, and repeatedly set up the list of *global systematically important institutions* (banks and insurers), based on the end-year data from the previous year. At the same time, it *abolished its working party on the development of reinforced disclosure requirements*, because it expected no material progress with regard to the risk publication of large banks. In addition to the *fifth report on resolution*, it prepared an *Additional guidance to resolution planning*, and in early June it published a *Guidance to the resolution planning of insurance undertakings of systemic importance*. In October it published a *methodology for the evaluation of the implementation of key crisis resolution elements in the banking sector*, and in mid-December it published two consultative documents fostering resolution planning and resolvability. One of them lays down the basic principles *facilitating the establishment of G-SIBs' internal TLAC*²² requirement and regulating the *cooperation of crisis management groups (CMGs)*, and the other intends to facilitate *the accessibility of financial market infrastructures (FMIs) by companies subject to resolution*.

The Progress Report on the implementation of the CCP work plan and the discussion note on CCP resolution planning aims to reinforce financial infrastructures.

²¹ Global systemically important banks

²² total loss-absorbing capacity

In the spirit of transforming *shadow banking* activity into safe market funding, in May the FSB published a thematic peer review on *the application of regulatory frameworks on shadow banking activities*. In addition to these, it prepared a *Progress report on the implementation of the OTC derivative market reform and addressing barriers to reporting transaction data*, and on *implementation of recommendations for reform of major interest rate benchmarks*, and a peer review on *the application of G20/OECD corporate governance principles*.

In 2016 the FSB prepared its **annual report** on the implementation and effects of financial regulatory reforms for the second time, published just ahead of the Hangzhou G20 Summit. According to that report, the implementation of these rules is continuous but not even and, as a result of the flexibility reinforced by the reforms, the state of the global financial system is good. The biggest internationally active banks are much more stable than before the crisis and fulfil the Basel III capital adequacy and liquidity standards, while maintaining lending to the real economy. The introduction of the TBTF rules is well advanced at most G-SIBs, but there is still a lot to do in the areas of building effective cross-border resolution regimes and making the resolution regimes of cross-border firms operable. Important results have also been achieved in strengthening the stability of financial markets, but a lot of work remains to be done with regard to the reform of OTC markets and the transfer of shadow banking activities to market financing. This report initiated that, for the effective operation of resolution action, the G20 leaders (i) grant a legally valid authorisation to share information cross-border in order to ensure the immediate and effective operation of foreign recovery actions; (ii) eliminate legal obstacles to reporting OTC derivative transactions to trade repositories and those of access to the data by authorities; and (iii) remove the other legal, data and capacity limits that set back the introduction efforts.

In order to deal with new and emerging vulnerabilities in the financial system, the FSB made numerous regulatory steps, including in particular, but not limited to, the preparation of the second Progress report *measures aiming to mitigate conduct risks*; and a Progress report on the *Second Phase of the G20 Data Gaps Initiative*. In addition to the updated progress report, it developed an *action plan on the decreasing availability of correspondent banking activity*. In June it launched a public consultation on *the economic policy proposals aiming to manage structural vulnerabilities in asset management activities*. Parallel to this, IOSCO²³ made proposals for the *treatment of data gaps characterising asset management activities*. Apart from the above, the FSB also dealt with the *systemic risks posed by corporate financing structures*; the *use of LEI*²⁴ in a wider range, and *financial risks related to climate change*; and a joint IMF, FSB and BIS publication was prepared on ***the elements of an effective macro-prudential policy***.

According to the work plan presented at the November meeting of the FSB in London, the finalisation of a guideline for the resolution and resolution planning of central counterparties, handling the decline in correspondent banking activities, work on conduct risks and the transformation of shadow banking activities into a reliable market-based form of funding as well as authorities' duties with respect to FinTech challenges, will be carried over to 2017. A separate task force deals with financial disclosure related to climate change.

Basel Committee on Banking Supervision

In its 2015 and 2016 biannual work programme, the Basel Committee on Banking Supervision focused on upgrading regulation; on striking the right balance between the simplicity, comparability and risk sensitivity of regulation; on the follow-up of the implementation of the Basel Accords and

²³ International Organization of Securities Commissions

²⁴ Legal Entity Identifier

the examination of their effects, and on improving the effectiveness of supervision. It intended to complete the programme on the management of excessive volatility of risk-weighted assets by the end of 2016.

Since 2012, the Committee has examined every six months, *under the RCAP*²⁵, the timely implementation of the Basel set of rules and evaluates the consistency and completeness of that implementation, including significant departures from regulatory frameworks. This evaluation is completed on a thematic basis and also for individual jurisdictions. The eleventh Progress report, with an end-September 2016 cut-off date, focused on the introduction of risk-based capital standards, capital buffers, the LCR indicator, and the implementation of the G-SIBs and D-SIBs²⁶ regulatory frameworks but, as of 2017, this exercise will be complemented with the implementation evaluation of the NSFR²⁷ and the leverage ratio regulation.

In 2016, the Basel Committee updated and consolidated procedures and processes on jurisdictional assessments in its *Handbook on jurisdictional assessments*. The *Second report on risk-weighted assets in the banking book* was also prepared under the RCAP and it examined the extent of differences in setting RWA by banks calculating their regulatory capital requirement by using the internal rating-based approach, and presented best practices for the independent validation of the bank model.

In its biannual reports examining the quantifiable effects of the *implementation of the Basel III regulation*, the BCBS reports how capital adequacy and liquidity indicators of banks covered by the exercise are developing, assuming fully-fledged (without transition) implementation of that regulation.

In 2016 the Basel Committee worked progressively *on the completion and finalisation of the financial reform decided in the wake of the crisis*. As part of the *balancing simplicity, comparability and risk sensitivity across the regulatory framework programme*:

- *It reviewed the set of rules and capital requirements on the management of market risk* This revision covered, amongst others, the boundary between the classification in the banking book and trading book; the revised model based approach; the reinforcement of the model validation, the treatment of hedge transactions and portfolio diversification more prudently than earlier; and the market liquidity risks. The revised standardised approach serves as an opportunity for step back and a lower threshold for model based approach, and enables to make market risk reports consistent amongst banks and jurisdictions.
- *It published a consultation paper on the review of the operational risk capital requirements.* The revised SMA²⁸ cures numerous weaknesses in the current framework and replaces current methods, including the AMA²⁹ and in this way the regulatory framework is simplified to a great extent. This revised methodology combines business indicators with companies' historic operating losses. The Committee is conducting a quantitative impact assessment for the final calibration of the SMA.
- *It launched a consultation on the review of IRB³⁰ approaches used for setting capital requirements for credit risks, with the view to decrease the number of model variations.* The proposed changes mitigate the complexity in the regulatory frameworks and improve comparability, and also decrease excessive variability in credit risk capital requirements. The option of using the IRB approach will be terminated for some exposure categories;

²⁵ Regulatory Consistency Assessment Programme

²⁶ Domestic Systemically Important Banks

²⁷ Net Stable Funding Ratio

²⁸ Standard Measurement Approach

²⁹ Advanced Measurement Approach

³⁰ internal ratings-based

parameter thresholds will be applied for certain exposure category; and a more precise specification is provided for parameter estimates.

The following elements are also included in ***the completion of the Basel III regulatory package***:

- *Consultation on the review of the third pillar, the disclosure framework.* The consultation paper issued in March 2016 contains the set of indicators for key ratios, and draft disclosure requirements for hypothetical RWA calculated using the standardised approach, and prudent valuation adjustments, as well as elements reflecting the ongoing regulatory reform (TLAC requirements for G-SIBs, and disclosure requirements for operational risk, market risks, and banking book interest rate risks).
- *Consultation on the review of the leverage ratio.* The simple, transparent and non-risk based leverage ratio was intended to complement the risk sensitive capital adequacy regulation. (This ratio must be calculated for the tier 1 capital; its expected minimum value is 3%.) The consultative document, published in April, proposes changes, amongst others, for the measurement of derivative exposures, treatment of regular-way purchases and sales of financial assets, clarification of provisions for less liquid positions and prudential valuation adjustments, and the harmonisation of the conversion factors for off-balance sheet items. The Committee considers imposing a leverage ratio requirement higher than 3% for G-SIB banks.
- *Treatment of interest rate risk in the banking book.* In April, the BCBS published its standard on the treatment of IRRBB³¹, which is a revised and updated version of the 2004 document. This regulation, containing supervisory expectations on the identification, measurement, monitoring and treatment of IRRBB, decided to deal with IRRBB in the second pillar. This new standard gives more detailed guidance than the earlier one on the expectations related to the IRRBB treatment process (shocks, stress scenarios, model conditions). It introduces a renewed and more risk-sensitive standardised approach, sets reinforced disclosure requirements, and more narrow threshold values for banks not compliant with interest rate standards.
- *Revision of securitisation frameworks; capital requirement for STC³² securitisation.* In July, the BCBS published the revised framework for the treatment of securitised claims, which contains the capital requirement for simple, transparent and comparable securitisation. This standard prescribes the fulfillment of additional criteria for the preferential treatment of SCT exposures. The lower threshold for the STC securitised claims risk weight was decreased by the Committee to 10% from 15%, as set out in the November 2015 consultation paper.
- *Finalisation of the TLAC regulation.* In early October, the BCBS also published the final regulation on capital requirements for holding TLAC instruments. This standard complements an FSB paper from one year earlier (*The principles on the total loss-absorbing capacity (TLAC) of G-SIBs in resolution and the associated term sheet*) imposing a minimum TLAC requirement for G-SIBs on the liabilities side. In parallel with this, the BCBS consulted with the stakeholders on the prudential treatment of TLAC instruments held on the assets side. The aim of this new standard is to mitigate the contagion effect in case of the potential resolution of G-SIBs. The new regulation enters into force, together with G-SIBs' minimum TLAC requirement, on 1 January 2019.

The final calibration of the above described ongoing regulations will be influenced in most cases by the outcome of the quantitative impact study conducted in 2016.

³¹ Interest rate risk in the banking book

³² simple, transparent and comparable

In the context of the Basel III regulation finalisation, the banking sector indicated in several fora its concerns that ***the revised and significantly amended rules will substantially increase capital requirements for banks using the internal model approaches.***

At the end of August, the *Canadian, European and Japanese Banking Associations* addressed a letter to the Chairman of the BCBS arguing for the use of the internal models. They declared that the new standards being prepared by the Basel Committee would be detrimental to the economies and banking systems of the authors of the letter; they would significantly increase capital requirements subject to an unchanged risk level and unnecessarily restrict the banks' lending capacities.

At the end of August, the *European Banking Federation* presented its reservations concerning the finalisation of the so-called "Basel IV" regulation in the *media*. It held that it considers the implementation of the Basel III regulation complete; the European banking system reached the objectives originally set out in the Accord. It presented that the Basel Committee's further proposals would greatly (according to a calculation in the base scenario, by 55%) increase capital requirements for European banks; it explained why lower risk weights, ensuring level playing field, follow from the characteristics of the European banking system, and also it outlined what to do to ensure that regulation acceptable to European banks is developed.

GHOS³³ also confirmed in its *press release* of 11 September on the finalisation of reforms that the Committee should pay attention to avoiding any significant increase in the overall capital requirement. In its *mid-September meeting*, the BCBS also considered that the proposed changes would have too great an effect on banks setting their regulatory capital requirement using the internal model. (According to leaked information, the European stance was very firm and argued for recalibration in order to decrease the effects.)

The European members of the BCBS, together with the Japanese, might be powerful enough to block the proposed finalisation of the reform, and even if the change is passed in the BCBS, the European Commission might reject its implementation. (The amendments taking shape in the process of finalisation are detrimental to Europe because the incidence of bank intermediaries is higher in Europe; the EU and Japanese banks lead the way in applying risk-sensitive model approaches and, in the EU, all banks are subject to this set of rules.) Valdis Dombrovskis, Vice-President of the European Commission, the Latvian Commissioner (appointed after the Brexit vote) in charge of Financial Stability, Financial Services and Capital Markets Union, spoke openly about the *option of refusing implementation*. He stated that although the EU Commission supports the BCBS' efforts to mitigate the unfounded variability of risk weights, it will however not support a solution that fails to consider the characteristics of (EU) banks and is not supported by an appropriate impact assessment. It is necessary to ensure that the finalised regulation treats mortgage loans, corporate and infrastructure loans appropriately. The EU Commission does not believe in the necessity to put a minimum threshold on the capital requirement established using internal models, on the basis of the standardised approaches, and it supports a regulation that will not worsen the competitiveness of EU banks compared to their global competitors.

At the same time the IIF³⁴ encouraged the BCBS to be transparent when finalising the regulatory framework.

In its meeting held in Santiago de Chile, the BCBS finalised its recommendations concerning the completion of the Basel III regulatory package. The outgoing chairman of the Committee, Stefan Ingves, stressed that the package will reduce the excessive differences observed in risk-weighted assets, and will not increase the general capital requirement significantly. The chairman added that it was already time to regard the package as final, and to concentrate on its implementation and future supervision.

After the announcement in Chile, in its letter to the *European members of the BCBS, the representatives of the European Commission and European finance ministers*, the EBF objected to the

³³ Governors and Heads of Supervisions: the body of central bank governors and heads of supervisory authorities from the Basel Committee members.

³⁴ Institute of International Finance

use of output floor with respect to internal models. Due to the mortgage loans remaining in their portfolio, banks' substantial share in financing and the Pillar 2 capital add-ons, put European banks at a competitive disadvantage. As the TLAC and MREL³⁵ requirements are also calculated based on risk-weighted assets, the output floor prescribed for RWAs is actually imposed on IRB banks twice.

In the first days of January, the GHOS published a press release to announce the postponement of the adoption of the post-crisis regulation's missing elements. According to the announcement, the Basel Committee needs more time to finish the work and for the final quantification.

Out of the papers published in the previous year by the Basel Committee, ***going beyond the Basel III regulatory package***, it is worth noting *the draft guidance on the prudential treatment of problem assets*, which sets out, in addition to the definition of non-performing exposures and forbearance, the disclosure requirements applicable to them. The *consultation paper and discussion paper on the regulatory treatment of accounting provisions*, dealing with the regulatory treatment of accounting provisions in view of the new accounting standards applying the expected credit loss approach. Technical reports on correspondent banking activities and the report on regulations aiming to strengthen the stability of central counterparties, and the establishment of the unique product identifier (UPI) also fit in the global regulatory work plan.

European regulation

In 2016 the ***general framework*** for European regulation was substantially determined by the uncertain political environment; the referendum that decided on Great Britain's exit from the EU, and the internal tensions related to the refugee issue. The statements made by the President of the Commission and the Council after the Brexit decision stressed the preservation of the EU's unity but also acknowledged that the European Union lives in one of the most difficult and critical times in its history. Although following the Bratislava EU Summit in September the heads of Member States reinforced their intentions to cooperate after Brexit, and undertook to present an attractive vision of the EU to their citizens, an EU worthy of support and trust, no substantial progress has been made so far.

Despite the unfavourable environment, bodies in charge of promoting regulation i.e. the Commission and the (Dutch and Slovak) presidencies sought to comply with the pre-set priorities and the demand to accelerate reforms and to keep legislation on its normal course. The initial ambitions focused, in addition to deepening the Economic and Monetary Union, the reinforcement of the Banking Union, the establishment and development of the Capital Market Union, strengthening the coordination process within the European Semester and support for action against tax fraud and tax evasion. In addition to this, the Eurozone Finance Ministers also set structural reforms, facilitation of employment, strict fiscal policy and debt reduction as priority tasks.

On 29 January the Commission launched, under the *REFIT*³⁶ *Platform* name, *the REFIT Programme* published in spring 2015 under the *Better Regulation Agenda*, aiming to make European regulation more simple, appropriate and effective, to decrease costs arising from regulation and to facilitate the creation of a framework providing for clear, solid and predictable regulation and lending momentum to growth and job creation.

³⁵ Minimum Requirement for own funds and Eligible Liabilities (TLAC and MREL requirements serve the purpose of ensuring that the institution has sufficient bail-in-able liabilities in an eventual resolution. TLAC requirements set by FSB apply to G-SIBs, and MREL standards under EU law apply to all European banks.)

³⁶ Regulatory Fitness and Performance Programme

After the Brexit decision, with regard to finances, the most significant announcements were the *acceleration of the completion of the Capital Market Union, the extension of the Investment Plan for Europe, and to double the financial capacity of the European Fund for Strategic Investments*.

In late November, the European Commission published a communication *on the results from the Call for Evidence on EU financial services*. Based on the responses received during the consultation, the Commission evaluated the interaction and aggregate economic impact of individual rules, and revealed the unintended effects, inconsistencies, and deficiencies linked to the regulatory framework, and it concluded that no change is required in the general EU framework for the regulation of financial services. However, targeted follow-up actions to fine-tune the framework were proposed in the following four areas:

- Removing unnecessary regulatory constraints on financing the economy.
- Enhancing the proportionality of rules.
- Reducing undue regulatory burdens.
- Making rules more consistent and forward-looking.

The Commission prepared a separate report on the European Market Infrastructure Regulation (EMIR), which deals with the improvement of the regulation of OTC derivatives, central counterparties and trade repositories.

In parallel with the communication, the European Commission also published its **proposal on the conclusion of the Basel reform package's implementation**, which contains the amendments to the Capital Requirements Regulation and Directive (CRR/CRD4), the Bank Recovery and Resolution Directive (BRRD) and the Single Resolution Mechanism Regulation (SRMR). The rules were developed based on the accepted global standards, taking the features of the European banking sector into account. This regulatory package contains measures aimed (i) **at increasing the resilience of EU institutions and enhancing financial stability**, (ii) **at improving the bank lending capacity to support the EU economy**, and (iii) **to facilitate the role of banks supporting the Capital Markets Union**.

The key elements of the Commission proposal to **increase the resilience of EU banks** are as follows: introduction of a 3% leverage ratio; introduction of the net stable financing ratio; overhaul of the trading book regulation, lowering the capital requirements for STC securitisation and covered bonds; retaining the SME supporting factor and extending it to all SME loans; decreasing capital needs of infrastructure projects; strengthening the proportionate application, decreasing the reporting and disclosure burden for smaller banks, simplification of capital requirement for trading positions, easing remuneration rules; amending the rules for large exposures; harmonisation of rules on the rank of creditors; integration of TLAC rules on G-SIBs into the MREL requirements; and reinforcement and harmonisation of the right to order moratorium to facilitate early intervention. At the same time, the Commission also supports the creation of deeper and more liquid European capital markets.

In 2012, EU political leaders decided to create the Banking Union, in order to manage the deepening crisis. In addition to the Single Rule Book, the first **pillar of the Banking Union** to establish was the **Single Supervisory Mechanism (SSM)**, under which the European Central Bank is in charge of the direct supervision of significant Eurozone banks (129 of the largest banks and banking groups) as of November 2014. The ECB's supervisory activity is focused on the harmonisation of supervisory methodologies, the creation of a common SREP³⁷ methodology; reduced and uniform treatment of NOD³⁸, and participation of SSM in the establishment of the international regulatory framework. In 2016, increased attention was paid, in addition to the control of credit risk, capital adequacy and liquidity, to the examination of risks affecting business models and profitability, and risk management policy and data quality.

In 2016 the ECB also published a regulation, a guidance and an Addendum, and a consolidated guidance on the use of national options and discretions. These provide for the uniform use of the

³⁷ Supervisory Evaluation and Review Process

³⁸ National Options and Discretions

NODs to be decided in supervisory competence by significant institutions subject to direct supervision; their primary purpose is to assist in the activity of the joint supervisory teams. As a further step in the standardisation of supervisory practice, the ECB presented a draft guideline and recommendation for consultation on the exercise of options and discretions with regard to less significant institutions. (The European Commission also considers the option for harmonising NODs in Member State competence.)

In the spirit of uniform supervisory practice, the ECB published on its website, already in January, its expectations on *ICAAP³⁹ and ILAAP⁴⁰ processes examined in SREP*, and the related reporting, then at the end of the year it published the results of the 2016 SREP. Harmonisation of the SREP review and the validation of banks' internal models is an important priority for the SSM.

In September the ECB launched a public consultation on the draft guidance on non-performing loans (NPL), under which banks with a high level of NPLs must establish a clear strategy, aligned with their business plan and risk management framework, to manage effectively and reduce their NPL stock in a credible, feasible and timely manner.

Out of the 2016 ECB publications in the SSM function, the following need to be highlighted in any case: *Public guidance on the review of the qualification of capital instruments as Additional Tier 1 and Tier 2 instruments*, the *supervisory statement on governance and risk appetite of Eurozone banks* and the *draft guidance on the appropriate and prudent assessment of the Board*.

The Anacredit⁴¹ regulation adopted by the Board of the ECB serves as a basis for the construction of the database of loans extended by Eurozone credit institutions. The collection of individual credit data in the Anacredit is an innovation and a great help for the ECB to fulfill its tasks as well as possible in terms of monetary policy, financial stability and risk analyses, bank supervision, scientific research and the development of new statistics. The launch of the Anacredit regulation is supported by a Manual developed by the ECB.

In terms of crisis management, the *establishment of a consistent methodology of recovery planning and the assessment of the completed plans* is also within the ECB's area of competence. Results achieved in this area were presented in workshops held on this topic.

The other important pillar of the Banking Union, the **Single Resolution Mechanism (SRM)** only became fully functional in 2016. The operation of the SRM was supported by the *Commission delegated regulations* related to the BRRD and the SRMR (e.g. *on the investment strategy and management of the Single Resolution Fund (SRF) on the content of recovery and resolution plans; on the exclusion criteria from bail-in; and the methodology, criteria for setting the MREL for institutions; on setting resolution reporting obligations; or on the group level resolution, and the operation of resolution colleges*, etc.)

In the context of resolution, in 2016 the integration into the EU legislation of the global regulations on TLAC and the amendment of the previously adopted EU legislation on MREL in line with it are the greatest special policy tasks. In terms of the credibility of the Banking Union, it was essential that the *financial instrument for the direct recapitalisation of banks (fiscal support) was adopted*. The public consultation launched by the Commission *on the macro-prudential regulatory framework* also contributed to the strengthening of the Banking Union.

The Single Resolution Board (SRB), set up in January 2015 under the management of Elke König holds an *official consultation* twice a year with the participation of the industry and other stakeholders. In the consultations held in the last year, the key issues were as follows: work programme for resolution planning and main elements of resolution plans; current developments in connection with the MREL regulation; simplified obligations for less significant institutions; contributions to SRF and the administrative expenses of SRB.

³⁹ Internal Liquidity Adequacy Assessment Process

⁴⁰ Internal Capital Adequacy Assessment Process

⁴¹ Analytical Credit Dataset

In 2016 the SRB prepared and published the *Resolution planning manual*, developed the *data need that serves as a basis for determining the MREL* (liability data template (LDT)), and started developing the MREL policies in cooperation with the stakeholders. Furthermore, the SRB conducts negotiations on the critical functions, access to FMIs, the provision of liquidity during resolution, and on international cooperation. In addition to the assessment of resolvability, the goals also include the identification and elimination of the obstacles to resolvability. In 2017, the SRB plans to determine the legally binding, institution-specific MREL requirements.

The creation of **single deposit insurance** was postponed upon the launch of the Banking Union, but in November 2015 the Commission submitted its proposal, under the slogan of completing the Banking Union, to create the **European Deposit Insurance Scheme (EDIS)**. Under this proposal, the EDIS would be established gradually, in three stages (*reinsurance, co-insurance, full insurance*) **by 2024; and by that date the joint fund would be filled up to the target level of 0.8% of the insured deposits.**

The stakeholders worked hard in 2016 to establish the EDIS. The Ad Hoc Working Party (AHWP) set up to strengthen the Banking Union mainly negotiated the terms of technical feasibility; the Dutch and Slovak Presidencies prepared progress reports on the results achieved. The *ECON*⁴² *Committee of the European Parliament* published a working document, then in October the *long-awaited impact assessment by the Commission*, considered as a precondition for moving forward by numerous stakeholders, was published. In this impact assessment, the Commission assessed three possible arrangements with respect to deposit insurance in the banking union: mandatory reinsurance, mandatory lending and a common (deposit insurance) fund. In addition to underlining the compromise that was reached, the preliminary report of the parliamentary rapporteur highlighted the finding of the impact assessment that all three options under review entail a stronger deposit insurance scheme than the current national-based system. According to the rapporteur's proposal, the reinsurance phase would be implemented as early as 2019; however, the other two phases (co-insurance, fully common fund) would be introduced later, after the adoption of certain risk-reducing measures specified in the report.

Both Member States and Members of Parliament have rather different views on the establishment of the EDIS. It is probable that the implementation of the scheme will not follow the schedule anticipated by the Commission, and opinions also differ with regard to the form of its implementation.

The creation of the Capital Markets Union (CMU) is the new priority in financial fields specified by the new bodies of the EU to be set up after the EU elections. As *part of the Action plan to establish the CMU*, the Commission launched a consultation on the *regulatory framework for financial services*; then later on *covered bonds*, and *effective bankruptcy regulation (insolvency, restructuring, second chance)*. It published its proposals on the Regulation on *STS*⁴³ *securitisation* and the *related amendments to the Capital Requirement Regulation (CRR)*, and the *Regulation on money market funds*. After the Brexit decision, the Commission seeks to accelerate the process of establishing the Capital Markets Union, hoping that people will soon be able to recognise and appreciate the results achieved. The Programme covers the *overhaul of the prospectus regulation, to make it more simple, quick and cheap*; the *Green paper on retail financial services*, and the *creation of the operational conditions for the European Pension Market*. By *amending the Solvency II regulation*, the Commission intends to achieve that insurance funds are able to participate in the funding of European infrastructure investments, while the so-called Green Bond scheme encourages sustainable investments.

⁴² Committee on Economic and Monetary Affairs

⁴³ Simple, transparent and standardised. (The global and EU regulator do not use identical terminology but STC and STS securitisations are identical in their content, since standardised products can be compared.)

Investment decisions are highly influenced by taxation matters. In cooperation with the Member States, the Commission takes efforts to avoid double taxation and to develop a Code of Conduct supporting best practices. They want to terminate the distortion where taking out a loan can be more favourable than issuing shares.

In the context of the acceleration of the CMU, the Commissioner in charge of that field highlighted that the completion as soon as possible of the Capital Markets Union plays an important role in the promotion of the ultimate goals of the Commission, namely growth and employment. The Commission proposals aiming to establish the CMU can help to improve access to financing by businesses, more precisely by SMEs.

In September, Commissioner Valdis Dombrovskis addressed a letter to the Parliamentary rapporteur and shadow rapporteur for the **Banking Structural Reforms**, stating that the Commission remains determined to implement the structural reform but an initiative from the Parliament would be needed for progress. There is still no agreement among the various groups in the European Parliament regarding the necessity of the banking sector's structural reform and there were no significant developments in this issue in the last year.

The 2016 activity of the **European Banking Authority** focused on the development and maintenance of the Single European Rule Book; the facilitation of the effective and coordinated crisis management of credit institutions, investment firms and money market infrastructures; the promotion of the convergence of supervisory methodologies and practices according to high standards; the identification and analysis of potential cross-border and cross sector micro-prudential risks; the establishment and maintenance of the joint supervisory reporting framework; and the protection of consumers, and monitoring financial innovations.

The **European Banking Federation** performed extensive lobbying to influence the content of the upcoming EU and global regulations, to ensure a level playing field and to protect the interests of EU banks.
