HUNGARIAN BANKING ASSOCIATION

REPORT
on Activities of the Hungarian Banking Association
3rd Quarter 2011

Budapest, October 2011

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Management summary

In the 3rd quarter of 2011 the Hungarian banking Association went through one of the most intensified period of its history – mainly because of the extremely rapid changes on the regulatory environment. As the result of the negotiations between the Hungarian Government and the Association in the first half-year, the Home Protection Action Plan, including 5 measures, was announced on May 31. Although there was no official signing, however the Government has started the execution of the Action Plan, which consisted of the introduction of fixing FX rate of repayment of retail mortgage loan denominated in foreign currency (so-called "FX rate bar"), elaboration of interest subsidy program, the establishment of National Asset Management Company, the release of foreclosure moratorium and instead, introduction of quota system for the foreclosures, and allowing the retail mortgage lending in foreign currency again.

The Hungarian Banking Association – while its members prepared for the implementation of FX rate bar and the related escrow account came in to effect as of August 12 – regarding the above issues provided its standpoints in several times and sent its suggestions to the Ministry of National Economy, as well as held consultation with the Chambers of Chartered Accountants.

At the same time in mid September the Government– omitting any preliminary consultation – have the act on full early prepayment of FX retail mortgage loans passed by the Parliament in record short period, which has to be amended at many points since then. The Board of the Hungarian Banking Association prior to passing the referred act explained its professional standpoints and solicitude regarding the applicability of the act and its consequences on the national economy. After passing the Act by the Parliament the Banking Association turned to argue at the President of the Republic asking for preliminary control of the law. After being unsuccessful of this initiation based on fundamental legal preparatory works the constitutional solicitudes regarding the act in question were explained in the application submitted to the Constitutional Court. Meanwhile the Banking Association informed the public through press releases and turned to the European Banking federation on professional relation, while the members had prepared for implementation fully complying with the Act.

As important element of the previous arrangement during autumn the National Asset Management Company (NAMC) was established, in which at preliminary stage the representatives of Banking Association were also participated. The law proposal on NAMC applied the purchase values fixed in the agreement at the end of May, however the establishment of the Company has been significantly changed compared to the original conceptions. In addition, in the last weeks another element of the Action Plan was started to be set up: the preparation on state subsidy to support individuals moving to a smaller flat as part of the new social political subsidy related set of measures.[1]

The Hungarian Banking Association noticed with pleasure the after long lasting lobbying efforts – in relation with the Home Protection Action Plan – the Parliament passed an act on comprehensive credit bureau ("positive" debtor list). Unfortunately, the rapidly approved Act in many aspects encumbers to fulfill the major purpose of the Act, thus we submitted our amendments to the Ministry of National Economy, and as consequence the correction of the Act is under the process of Parliamentary admission.

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[1] The detailed elaboration of the regulation was concluded in October, thus the details will be available in the report of the forthcoming quarter
A szabályok részleteinek a kidolgozása októberben történt, így a részletes ismertetés a következő negyedév anyagában lesz olvasható

Another important event of this quarter was that the Financial Arbitration Board has started its operation. The Banking Association initiated its solicitudes against the proposed organizational framework even at the time of preparation on the relevant legislation. The most important problems we see is the integration of the Board into the organization of PSZÁF. The passed over 100 days of its operation seems to confirm such anxieties that it was not managed to properly separate the operation of the Board from PSZÁFS supervisory activities and in certain cases the penalties imposed by the PSZÁF upon the process of the Board seems to be exaggerated.

Among the financial regulatory issues having preparations in the European Union currently, in the past quarter, we had active participation by providing our standpoint in case of the self-regulatory work on transparency of bank account fees, while upon the request of the Ministry of National Economy we provided our opinion regarding the draft EU directive on mortgage lending in more turns.

Even the most important event of the EU regulatory works was the proposal of the Committee on European implementation of Basel III treaty on capital adequacy and liquidity (CRD4, CCR) that was published in July, while on global scale the ruling of systematically important institutions (SI-Fis, G-SIBs) was in the focus.

I. REGULATION, SELF-REGULATION ISSUES

1. Home Protection Action Plan[2]

1.1 PSZÁF CEO letter on overflow account loans

The Hungarian Financial Supervisory Authority (PSZÁF) issued CEO letter No. 5/2011 on expected banking practices mindful of consumer interests in relation to Act LXXV of 2011 on the fixing of repayment rates for foreign currency loans and on foreclosures. In view of the importance of the CEO letter and the related consumer information and calculator, we held a special consultation with those specialists from banks who had been involved in the drafting of the Home Protection Act. Participants were of the opinion that the documents in question help costumers and banks to prepare themselves for applying the legislation. The tasks set in the CEO letter could be implemented, although some tasks involving system development needed more time.

We drew PSZÁF's attention to some issues that should be considered: the CEO letter included certain points providing extra tasks for financial institutions beyond those provided by law, thus PSZÁF seems to act as a legislative authority.

1.2 Accounting issues related to overflow account loans

To ensure consistent accounting for the new overflow account loans created pursuant to Act LXXV of 2011 on the fixing of exchange rates for foreign currency loan repayments and for the underlying foreign currency loans, the Association's accounting specialists developed a method that can be accommodated in the relevant accounting rules. We sent our proposal to the Ministry for National Economy. The main elements of this proposal are as follows:

- The overflow account loan and the underlying foreign currency loans should remain in the problem-free category, if the underlying foreign currency loan was rated problem-free prior to applying for the exchange rate protection.
- There should be no provisioning requirement for the three-monthly capitalised interest of the overflow account loan.
- The overflow account loan and the underlying foreign currency loans should be considered as restructured only if the underlying foreign currency loan was classified as special mention, substandard, doubtful or bad.
- Only the part of the loan not backed by state guarantee should be impaired.
- Regardless of the asset classification, banks will provide reporting on all relevant data and information on overflow account loans and the underlying foreign currency loans.

In contrast to our proposal, the PSZÁF-MNB common approach is more stringent:

- The overflow account loan and the underlying loan should be considered as restructured, irrespective of the underlying loan's category. That its: the underlying loan will also become restructured.
- Thus, at least 1 per cent of impairment must be recorded on both loans even though the underlying loan was problem-free.
- The quarterly capitalised interest on the overflow account loan should be subject to 100% provisioning.

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[2] Introduction of the Act is in the report on 2nd quarter 2011

- The rate of state guarantee for the overflow account loan should be gradually reduced from 100% to 25% by December 2014, 2011
- The classification of and the impairment requirement for loans rated lower than problem-free (those in arrears for more than 30 days and not more than 90 days) will remain the same, but the impairment may not be reversed.

The current Government Decree on accounting rules provides a concrete definition for restructuring and makes the classification of loans subject to individual rating. The PSZÁF-MNB approach treats restructuring in a much broader sense and, as opposed to individual rating, expects automatic impairment, that is, profit reduction due to the overflow account loan and the change in classification of the underlying foreign currency loan, thus reducing the banks' capital and lending potential.

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At the meeting invited by the Ministry for National Economy on the issue it seemed that the Ministry's approach was closer to ours:

- The Ministry does not support the imposition of 1% impairment requirement for problem-free underlying loans on the grounds of restructuring.
- The Ministry does not want to reduce banks' profits and thus, budget revenues, by an overprudential 1% impairment requirement (for banks, state guarantee fees and impairment are expenditures).
- The Ministry is interested in a preferential treatment of overflow account loans backed by state guarantees relative to similar self-developed banking products.
- The Ministry sees risks in the overflow account loan stock and the repayment of the underlying loans at current exchange rates once the fixed exchange rate period ends at the end of 2014. It expects certain reserves (impairment or provisions) to be made.
- This would be needed also because the rate of state guarantees backing the overflow account loans will suddenly fall from 100% to 25%. (Although according to the Ministry’s experts, the government may make steps to help again at the end 2014).

The Ministry promised to draft and enact the accounting rules for the special loans in question by October. It would be a pragmatic solution if the Ministry proposed accounting rules advantageous (or less disadvantageous) for banks and reverted to the issue again in 2013. We asked the Board for their personal intervention and support to achieve this.

1.3 Regulatory and central bank reporting, data collection related to the government's exchange rate schemes for foreign-currency denominated mortgage loans

The consultations on proposed regulatory and central bank reporting requirements for 2012 were concluded fairly early this year. Several of the proposals made by banks were incorporated in the final decrees. With the early issue of the relevant decrees, the 3-month notice time requested by banks in respect of regular reporting requirements can more or less be met.

During the consultation on next year's reporting requirements, the PSZÁF, in agreement with the MNB, introduced two special reporting requirements.

One is a detailed reporting requirement with a short deadline on overflow account loans and the underlying foreign currency loans. For consumer protection considerations, the number of customers expressing interest in these schemes also needs to be reported. Initially, difficulties in meeting the deadline were caused by the fact that the expected data are based on oral inquiries, not registered in banks' IT systems, therefore, these reports cannot not be automated. We told PSZÁF that more time was needed to develop the required internal processes and requested it to amend the reporting deadline. Another difficulty was that the reports included data whose interpretation was unclear due to the absence of specific accounting rules. Also, banks' accounting officers dispute the common approach taken by PSZÁF and the MNB, and neither does the Ministry for National Economy, responsible for regulation, fully share the approach (for more details see the chapter on accounting issues).

1.4 National Asset Management Company

The concept for the National Asset Management Company has been completed. The Association's Board also delegated members to participate in the review. The plan is that the National Asset Management Company (NAMC) shall purchase the homes of needy mortgage debtors with at least two children. The proposed legislation sets the purchase price as a percentage of the market price of the real estate on conclusion of the loan contract. The price purchase price will be 55% in Budapest and cities with county rights, 50% in other cities and 35% in other municipalities. First ranking mortgagees will receive a maximum of 80%, second ranking mortgagees a maximum of 50%, third ranking mortgagees a maximum of 25% and fourth and lower ranking mortgagees a maximum of 10% of the claim. The National Asset Management Company will purchase the real estates free of any liabilities/encumbrance. This means that the bank will have to forgive a part of its claim, but this will be up to the bank. If the bank does not approve the deal, the purchase will not take place. If the bank approves the deal, it will act as the NAMC’s agent in the purchase contract. The rights and obligations of banks and the NAMC will be stipulated in a cooperation agreement. The Act is expected to be passed by Parliament in October. The first agreements may be concluded in January 2012.

1.5 Consultation on notary deeds related to the Home Protection Act

We held a consultation with leaders of the Hungarian Chamber of Notaries on the incorporation into notary deeds of the unilateral commitment to be provided by the debtor in relation to the overflow account loan and amendments to the underlying foreign currency loan contracts. The meeting was attended by lawyers from member banks.

The Ministry of Administration and Justice issued Decree No. 25/2011 (VIII 22) amending Justice Ministry Decree No. 14/1991 (XI 26) on notary fees on August 22, 2011. According to the decree notary fees for incorporating the overflow account loan and the connecting unilateral declaration in a public deed under the act on fixing the repayment exchange rates of foreign currency denominated mortgage loans and the administration of foreclosure of residential properties shall be borne by the banks. The relevant fees are payable according to the general rules, that is, based on the time spent on drafting the deed rather than on the transaction value. We held a meeting with the Hungarian Chamber of Notaries on how the fees should be calculated and paid. At this meeting, we agreed that the payment should be made by bank transfer based on an invoice issued to the bank's name. We also agreed that it would be expedient to **use a standard sample deed** for the unilateral statement to be

provided by the debtor. This statement should include a unilateral commitment by the debtor in respect of both the overflow account contract and amendments to the underlying foreign currency loan contract. We also agreed on the contents of the statement.

The Hungarian Chamber of Notaries issued a Guidance for notaries on the notary service fees and reimbursements to be applied. Pursuant to this, if the proposed standard sample deed is used, the total notary fee, including reimbursements should be HUF 15,320 (HUF 23,720 if the procedure is carried out on site at the bank). We informed banks' legal counsels as well as the Association's competent working groups on the Guidance (Guidance No. 38).

2. *Early Repayment Act and Central Credit Bureau (CCB) Act*

2.1 Enactment of the Early Repayment Act

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

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

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

The Act had to be amended twice right after its adoption and there are still a number of unclear legal and other issues.

2.2 Early Repayment Act – Constitutional Court motion

The Board reviewed the situation created after the enactment of the Early Repayment Act at its Board meeting of September 19 and decided that a motion should be filed with the Constitutional Court within five days from the entry into force of the Act. The motion was drafted by an external legal expert in cooperation with the Association's Legal Working Group. On October 3, the Board reviewed the motion and approved that the motion, signed by the Association and those banks who are able to make a decision within the agreed deadline, be submitted to the Constitutional Court.
The motion, joined by 15 banks, was registered by the Constitutional Court under No. 1498/B/2011 on October 6, 2011.

In the motion, we requested the Constitutional court to declare the Act unconstitutional, as the way in which it had been adopted violated the principle of legal certainty and the rule of law. We submitted that in our view the Act unconstitutionally limits the freedom of contract and the right to property and violates the principles of a market economy and legal certainty.

In parallel with this, the ad-hoc legal working group consulted with the European Central Bank and two law offices experienced in international and EU law. We also gathered information from the European Commission Representation in Hungary on potential actions at the various EU forums.

2.3 Taxation issue related to the Early Repayment Act

As a result of the hasty legislative process, taxation issues remains open.The legislation failed to address the taxation rules for non-home mortgages; instead of "mortgage loans denominated in foreign currency", it spoke about "mortgage loans taken in foreign currency", and the procedural rules were also unclear. Therefore, we turned to the Ministry for National Economy, drawing attention to these deficiencies. We sensed that, as a response, Parliament adjusted the provisions on taxation within two days. Also, we requested the competent Ministry to provide a ruling on the taxation of the financial transaction applied on early repayment.

2.4 Fiscal and data-supply issues related to the Early Repayment Act

The law provides no special accounting rules regarding the change of the rating of foreign currency loans upon early repayment. Banks' accounting officers are of the opinion that this could be taken care of in each bank's accounting policies. At the meeting of the Money and Capital Markets Section of the Chamber of Hungarian Auditors, the Association requested auditors to provide guidance to ensure consistent interpretation of these products. In preparation of a potential technical conference on the issue, we compiled and sent to the Chair of the Money and Capital Markets Section of the Chamber a set of practical questions concerning the treatment of these items in Hungarian and international financial reports. We received a detailed written response to our questions.

In addition to the overflow account loan facility, banks are required to provide special reporting aimed at monitoring early repayments. Reports are to be filed on a weekly basis on the number of early repaid loans and the repaid amounts (basically transaction data), information on forint and foreign-currency denominated loans granted for the purpose of early repayment, in a breakdown of whether the loan is required to replace the borrowers' own or somebody else's foreign currency loan. The changes in foreign funding should also be reported, including whether the change has been due to maturity of debts or due to early repayment. In return for the extra burden imposed by the special reporting requirements we requested PSZÁF and the MNB to return the aggregate data to the sector, as this information is important for market players.

Also, in view of the increasingly frequent special reporting requirements and with a view to reducing reporting burdens, we requested that the current regulatory reporting requirements be reviewed and those of less importance cancelled, or at least suspended for the period of special reporting on overflow account loans and early repayments.

2.5 Association action regarding the Act on central credit bureau

Act CXXII of 2011 on central credit information system, submitted as an individual MP motion, parallel with the Early Repayment Act (as part of the home protection action plan) was passed by Parliament under urgency on September 19, 2011. The draft law had not been consulted on with the Association.

We agree with the main objectives and approach of the Act. At the same time, the Act contains a number of legislative and legal drafting errors, which may jeopardise the workability of the Act, the building of the new database and even the operation of the current central credit information system. Therefore, we turned to Ministry for National Economy, asking for urgent amendments to the Act.

The timeframes for the entry into force of the Act, costumer information and administration are too short and technically unworkable for banks and, in our opinion, for PSZÁF, BISZ Ltd. and the Hungarian Post Office, as well. Accordingly, we requested the Ministry to provide new transitional dates to allow financial institutions to meet the requirements of the Act. Also, we provided detailed text proposals to solve inconsistencies in the Act.

In cooperation with members and BISZ Ltd., the Association set up a project to implement the tasks provided by the Act. At the kick-off meeting of the Project Steering Committee, the representative from the Ministry for National Economy said the Act, taking effect on October 12, might be corrected within a short time. Referring to this the proposal was made in early November.

3. Payments

3.1 PSZÁF CEO letter on bank card practices expected from institutions

On September 1, PSZÁF issued CEO letter No. 6/2011 on bank card practices expected from institutions in unforeseen situations, mindful of consumer interest. Most of the expected practices, specified in nine points, are already met in general bank card and market practice. At the same time, certain questions arose concerning the practicability and implementation of some of the issues raised and concerning PSZÁF's concrete expectations. The Association Card Working Group collected and specified the issues needing clarification and the Secretary-General sent them in a letter to PSZÁF's President, asking for a personal meeting on the issues raised.

3.2 Creating a payments glossary within the framework of self-regulation

The Board decided that the Association should create a payments glossary in Hungarian and English within the framework of self-regulation. The proposed glossary would help eliminate misunderstandings arising from the divergent use of terms and may be a useful aid in the translation of EU legal documents.

A project work plan, including the breakdown of tasks, organisational rules, the working methods and main milestones for the project was drawn up.

Based on the project tasks, a Steering Committee was set up. Members of the Steering Committee include representatives from the MNB and the Hungarian SEPA Association, the Association's Secretary-General and the head of the Association's Payments Working Group. The Steering Committee reviewed, adjusted and approved the project work plan.

The Association requested members to appoint specialists to the various project working groups. This was done, the setting up of the working groups was in process at the time of writing this report.

3.3 Proposed increase in the MNB's cash transaction fees

The MNB has published its proposed cash transaction fees for 2012 in due time. The new fees, directly, and due to the ensuing necessary changes in banks' cash processes, would have meant significant extra costs for banks. Therefore, at the meetings organised by the MNB, the Association orally expressed its objections.

The MNB's objective in the fee increase was to ensure that only wholesale quantities are handled in cash trading between the MNB and banks and to promote efficient cooperation between banks in organising small cash deliveries into larger lots.

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

3.4 Hungarian SEPA Association

The Hungarian Banking Association actively supports the work of the Hungarian SEPA Association. Together with the MNB, we participate in the meetings of the various bodies of the SEPA Association and in its communications. We assist in communications of the SEPA Corporate Forum, organised jointly with PSZÁF, and analyse the information documents and communications issued by the European Payment Council (EPC).

3.5 Project for the implementation of intraday settlements in Hungary

The Association was involved in the work of the legal working committee set up within the framework of the project launched at GIRO for the introduction of SEPA-compliant domestic intraday settlements in Hungary. The working committee reviewed the proposed amendments to the business terms and conditions of the interbank clearing system and the draft clearing agreement.

4. Legal issues

4.1 New Labour Code

The Ministry for National Economy submitted the draft of the new Labour Code to broad discussion in July. During the discussion, the government stepped back from some key amendments.

The changes affecting the banking community are as follows: the severance ban for those in protected age has been relaxed, the proposal specifies those particularly warranted cases, where the employee may be discharged. The most important change in respect is that the employer's insolvency is considered to be such a case. In the case of pregnant women and mothers with minor children, the proposal returns to the current regulation, that is, they cannot be discharged during the protected period. The protection of privacy rights, including employees' personal data and the electronic surveillance of employees is addressed in the new Labour Code under a separate chapter. In relation to leave, a new element is the requirement for the employer to allow the employee at least 10 consecutive days of leave. The original proposal for the probationary period to be 6 months instead of the current 3 months was dropped. Employee's liability, originally proposed to be unlimited, will be capped, the current proposal is the 4-month average wage. The overtime limit, currently 200 hours, will be raised, although to a lower level than the originally proposed 300 hours. Non-regular remuneration (such as bonuses) will be excluded from the calculation of average wage. Shift allowances will be abolished, however, to prevent any wage decrease for those affected, the Ministry for

National Economy is working on a transitional provision allowing the building in of shift allowances into the base wage. The time allowance for trade union officers will be changed to be purpose-tied.
The Ministry concluded the broad discussion of the draft Labour Code in October and to submit the Code to the.

4.2 Verdict of the Szeged Court of Appeal

Upon a claim filed by the Csongrád County Chief Prosecutor's Office, the Szeged Court of Appeal voided a number of provisions of the general terms and conditions of Partiscum XI Savings Co-Operative as unfair. Each of the provisions in question was related to the unilateral amendment of contracts and is in full accordance with the Association's Retail Lending Code of Conduct and the Credit Institutions Act. As the case could have been used as a reference in other cases against banks, we considered it important to provide assistance to the defendant, which otherwise is not a member of the Association.

Given the keen public interest, the media could also report first hand on the Supreme Court's decision ordering the first instance court to conduct a new proceeding and declaring that in long-term relationships, contracts may be unilaterally amended, the rules for which, in the case of banks, are stipulated in the Credit Institutions Act.

This verdict will hopefully restrain others from initiating similar litigations. A background study was prepared to develop banks' defence in other litigations currently underway. The study was discussed in the Legal Working Group.

4.3 Proposed revision of the Act on Judicial Distraint

Our proposals, developed at the request of the Ministry of Justice, primarily related to the regulation of takeover by the creditor of the real estate if the auction is unsuccessful. In addition to this, we made a number of other amendment proposals to the legislation. Our main objective was to prevent fraudulent procedures and misuses detrimental to banks' interests. A number of our proposals were incorporated into the proposed legislation. We received the draft law for review with an extremely short notice in October.

5. Financial Arbitration Board

5.1 Financial Arbitration Board commences operations

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

5.2 Proposed information document on the Financial Arbitration Board's procedural fees

PSZÁF published on its website a draft information document on the Financial Arbitration Board's procedural fees. The document was sent to us for review. Based on members' proposals, we provided comments on the document, as it contained some inaccuracies and in certain points advantaged the consumer, inconsistently with the relevant laws. Also, we proposed that the fees of the legal representatives of the financial service provider should also be addressed.

6. Other issues

6.1 Proposal for amendments to the Act on Public Warehousing

Lending against warehouse receipt has dropped in recent years, mainly due to disturbances in warehousing activities. The decline has substantially weakened the collaterals for lending. In view of all this, we initiated amendments to the Act on Public Warehousing. The Ministry for National Economy, the Public Warehousing Authority and the Association of Public Warehouses supported our proposals. The working group set up for this purpose drafted and submitted specific text proposals to the Ministry.

However, the Ministry has not started the drafting process yet, saying the law would not be addressed by Parliament in the fourth quarter due to the busy legislative schedule. Now, we reiterated our request for starting the drafting process, as it would be needed for the legislation to be enacted in the first quarter of 2012, before the new warehousing season starts.

6.2 Regulatory issues arising from proposed amendments to the Energy Act

The new energy laws will substantially affect combined heat and power plants (around 190 in number). Banks have provided long-term loans for these plants, mainly under project finance schemes. As the new law will affect subsidies and prices, it is important that we can efficiently represent banks' views with a view to preserving the solvency of these plants. We are conducting negotiations with the Ministry and professional associations of power plants to develop a common position.

II. EU LEGISLATION - EUROPEAN BANKING FEDERATION COMMITTEES AND WORKING GROUPS

1. EU self-regulatory initiative on transparency and comparability of bank fees

The drafting of the proposed EU self-regulation on the comparability of bank account fees, initiated by the European Commission, has arrived at a final stage. The two sponsors, the European Commission and the EU Consumers' Organisation (BEUC) expressed serious criticisms of the proposal. The main points criticised included

- the selection method of services related to the bank account,
- the low number of services to be compared (credit transfers, direct debits, bank card payments)
- the inadequate involvement of national consumer organisations,
- the long implementation timeline.

Based on these points, a consultation took place between national banking associations and the European Banking Industry Committee (EBIC). In this process, the Hungarian Banking Association basically relied on the comments provided by the working group set up to address the issue. While expressing their willingness to make some minor adjustments, EU banks maintained their position that

1. comparing too many services would confuse rather than help consumers;
2. consumer organisations cannot play a major role in a self-regulation;
3. the implementation dates of a complex self-regulation cannot be shortened by command.

EU-level consultations were still in process at the time of writing this report.

2. *Proposed EU directive on mortgage lending*

At the request of the Ministry for National Economy, we provided comments on the proposed EU directive on mortgage lending in several rounds by drawing on the comments made by our ad hoc working group, made up of specialists from banks, and information documents provided by the EBF.

Given that there had been no progress compared to the previous versions, we maintained the criticisms we had earlier expressed on a number of issues (such as the requirement of mandatory explanation of the rejection of the loan application, the amount of information to be provided in advertisements, mandatory submission to a reconciliatory body). At the same time, we welcomed the proposal for host supervisors to also have jurisdiction over credit brokerage activities (for example, in respect of qualifications).

3. *European Banking Federation (EBF)*[3]

3.1 EBF Communications Committee

The Chair of the EBF Communications Committee (János Müller, Chief Advisor of the Hungarian Banking Association), in June reported to the EBF Executive Committee on activities of the Communications Committee and presented the Committee's proposal for developing a new communications approach for the EBF. The Executive Committee welcomed the proposal. It agreed with the need for a new communications approach and commissioned the Communications Committee to draft the new communications strategy. Based on this, the Communications Committee's meeting, attended by representatives from 12 member states, defined the key areas to be addressed in the strategy to be presented to the Executive Committee meeting in December.

3.2 Information and request for EBF support

We informed the EBF Secretary General on the enactment by Parliament of the Act on Early Repayment and on the Association's concerns. In accordance with our request, the EBF Secretary General informed the EBF Executive Committee and wrote a letter to the Hungarian Prime Minister, requesting him to reconsider the implementation of the Act. He emphasised that the provisions of the Act were incompatible with EU laws and raised concerns from the point of view of banks operating in Hungary and their parent banks in other EU member states. The Minister for National Economy dismissed the approach.

[3] We give detailed information about the EBF Banking Supervision Committee in attachment II.

III. ASSOCIATION EVENTS, WORKING GROUPS, COMMUNICATIONS

1. *IT Security Working Group*

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

2. *Municipalities Working Group*

The Municipalities Working Group compiled an analysis on issues burdening the relationship between banks and municipalities. Proposals were developed addressing the following areas: redirection of tax revenues from municipalities to the government, redirection of assets, rescheduling of existing loans, future account management, future funding of municipalities and the Act on Bankruptcy and other procedures covering municipalities. We presented the following facts: the municipalities sector currently has a debt stock of HUF 1,000 billion. This stock of debt is consistent with the amount of funding withdrawn from the municipality sector over the past years, which is exactly HUF 1,000 billion, while the functions assigned to municipalities have remained unchanged. "The sector was seriously under-financed especially in the period between 2002 and 2010. During these years, the previous governments took a total of 1,000 billion HUF out of the budgets of municipalities." (Municipality Reform Concept, May 2011, published on the Interior Ministry's website). In this situation, it was a rational solution for municipalities to resort to banks' lending and bond issuance services in order to preserve their operations and secure the funds required for their development projects. In the recent period, it was typically those local governments that became indebted which had adequate coverage and own revenues. Those members of the municipality sector that have more significant local business tax revenues may be regarded as the most solvent customers. Those municipalities with significant local trade tax revenues can be considered as the most solvent customers. The size of municipality debts is also influenced by exchange rate changes: more than 50% of the stock of debt is in foreign currency. (Nearly 50% of the stock of debt is in bonds, 79% of which is denominated in Swiss Francs). Loan and bond repayments are due from as early as 2011 and 2012. At the same time, the municipality sector is a significant depositor as well, therefore, the withdrawal of these deposits may soon cause liquidity risks to institutions actively involved in lending to municipalities. The Hungarian Banking Association as the association of banks that provide the bulk of financing for the municipality sector welcomes the financing-related sections of the municipality restructuring concept announced on the homepage of the Ministry of the Interior, in particular: 1) the declaration of the priority of mandatory responsibilities of the municipalities, 2) the reconsideration of central subsidies, assigned revenues and local taxes, and the regulation of their use, 3) the introduction of a task-based funding system 4) the provision that voluntary tasks may be financed exclusively from the municipality’s own funds 5) the clarification of rules for the alienation and encumbrance of municipality-owned assets. The HBA’s report outlines a realistic framework, based on the continued involvement of banks in municipality account management and funding, within the constraints of regulated competition. In banks' current practices, financing limits are defined based on the relevant laws, or the bank's own, stricter, rules, by assessing the municipality's own revenues and local tax collection

capabilities. Cash-flow based financing, rather than collateral-based financing, is the basic policy. A considerable modification of the income structure of local governments, and especially the withdrawal of their revenues and assets that serve as collateral for bank loans, would only become possible with a drastic transformation of their debt portfolio which is not the intention of market players. Local taxes are currently the only revenue source for municipalities that is based on the performance of the local economy. The use of these revenues for local purposes promotes local patriotism and morale. The proposals - for each of the problematic areas- were submitted by the head of the High-Level Working Group on Municipalities to the Board. In accordance with Board's decision, the report was sent to government, parliamentary and municipality officials. The State Secretary of the Ministry for National Economy agreed with our proposals.

3. *PPP and Macroeconimic Working Group*

The Ministry for National Economy wrote a letter to the Association's President, requesting the Association's cooperation regarding the proposed buyout by the state of PPP projects. The PPP Working Group drafted a reply to the letter. The reply was sent, but in the meantime, the government had dropped the plan, presumably for budget reasons.

In addition to the Municipalities and PPP Working Groups, the Macroeconomics Working Group also held a meeting in the third quarter. We reviewed the economic developments in the world and in Hungary, developments in the banking sector and discussed the expected impacts of the Early Repayment Act on banks on performance of banks and the economy as a whole.

4. *Basic Bank Account Working Group reinstated*

The European Commission in July issued a recommendation on access to a basic bank account. Pursuant to this, in any member state, consumers who are legally resident in the European Union and who do not hold a payment account in that member state should be in a position to open and use a basic payment account in that member state.

The Ministry for National Economy requested the Association to implement the recommendation through a self-regulation. At its meeting on September 5, 2011, the Association's Board decided that the introduction of basic bank accounts should be tied to the requirement for all salaries and social benefits to be paid into bank accounts. Accordingly, the Basic Bank Account Working Group was reinstated and compiled a discussion document on the issue.

In the meantime, the European Parliament's Internal Market and Consumer Committee (IMCO) had reviewed the Commission's Recommendation. It seems that the IMCO does not consider a non-binding recommendation to be sufficient and plans to issue and stronger norm. This may put the issue in a new perspective. What is certain is that more emphasis will be given to differentiation between two main target groups: on the one hand, the basic bank account is aimed to remove the barriers for EU citizens wishing to reside in any member state; on the other hand, the basic bank account is aimed to ensure access to basic financial services by citizens socially in need, by definition primarily or exclusively in their home country.

Tax evasion, so common in Hungary, will be a major regulatory consideration, given that it is tax evasion and not the potentially high account management fee that is the main obstacle to the businesses receiving and making payments into and from bank accounts.

5. *Cards Working Group*

At it monthly meetings, the Cards Working Group reviewed issues related to the implementation of the PSZÁF CEO letter on bank card practices expected from institutions. The Working Group compiled an opinion, based on which the Secretary-General wrote a letter to the President of PSZÁF.

The Working Group took up contact with the competent department of the MNB (Director Lajos Bartha and his staff) to ensure that banks can optimally meet the MNB's bank card reporting requirements and to introduce the practice of reviewing the figures and findings of the MNB's semi-annual bank card market reports at joint meetings with the MNB's competent staff.

In September, the Working Group completed the review and update of its contact list and re-launched the Association's weekly electronic publication, the Cards Newsletter.

6. *IG2 Communications Working Group*

The project for the introduction of SEPA-compliant intraday domestic settlements in Hungary was launched in June. Based on the decision of the Project Steering Committee, A Communications Working Group was set up. The Association is also represented in the Working Group and we are actively involved in its operations. In the third quarter, the forms and channels of customer information, including the target groups, the messages and the proposed schedule and intensity of communications were determined.

7. *Communications with the media*

The past quarter saw keen interest from the press. At the beginning of the quarter, the lifting of the eviction moratorium and the government's concurrently introduced Home Protection Plan with the fixing of exchange rates for foreign currency loan repayments were the main focus of media attention. Until early September, the Association's had engaged in vigorous communications, getting its key messages to policy-makers and the public. As a result of our efforts, a media environment with opinion-maker financial and business journalists being open to conveying the problems of the sector in a positive way had been created. From September 9, following the promulgation of the Early Repayment Act, upon the Board's decision, the Association confined its communications to press releases, with neither the Board members, nor the Association's staff making any other oral or written statements.

Further to this, we started the registration and monitoring of media appearances related to the Association. Between August 24 and September 30, we recorded 468 media appearances, including

- 148 in the print press,
- 48 in the electronic media,
- 268 in the online media, and
- four press releases.

There were 66 instances, where the Association was mentioned or criticised without us being contacted.

ANNEX I

ECONOMIC STUDIES

Three studies, one on the world economy, one on the Hungarian economy and one on banks' quarterly performance were prepared and sent to banks' CEOS in the third quarter. Below is a summary of the main points of these studies.

The world economy

The world economy continues the rebound started in 2010. After a 0.5% decline in 2009, output grew by 5.1% in 2010. It is expected to be 4.3% in 2011 and 4.5% in 2012, according to IMF estimates as of June 2011. World production is expected to reach the trend level it has followed over the past forty years by 2012. Developed and developing economies are on different paths. The developed economies have an average lead of four to five percentage points in growth rate, being in annual terms 6.2 percentage points in 2009 (2.8% vs. –3.4%), 4.4 percentage points in 2010 (7.4% vs. 3.0%), 4.4 percentage points in 2011 (6.8 % vs. 2.2%) and 3.8 percentage points in 2012 (6.4% vs. 2.6%). During the 35 years between 1973 and 2008, the developed economies lagged by 0.5 percentage points behind the world average. This lag has grown for the period 2009-2012 to more than 2 percentage points. Despite austerity measures introduced during the crisis, inflation remained under control, the modest 1% "hump" in 2011 is disappearing. The slower-growing developed economies are expected to see a below 2% inflation rate, the faster-growing economies may see a 5% inflation rate in 2012. Financial market volatility has grown, while the growth of the PIGS countries and Italy together may only be a phantom. There is a growing realisation in the eurozone that the Greek economy cannot be rescued, as its indebtedness is rapidly increasing, therefore, it should exit the eurozone. This, however, would imply that the eurozone not only has an entrance, but also an exit, it is a passageway rather than a destination and, with no common fiscal commitment, the currency snake is a better form of harmonisation than a common currency. Looking at the main components of the 2009 crisis: we listed the countries based on their paths between 1960 and 2008 into three categories depending on whether relative to their development and population they are below-average exporters (such as the USA, most of the Latin-American countries and the Nordic States), average exporters, (such as Japan, the largest EU member states and the post-socialist countries), or above-average exporters (such as China, India, Indonesia, Malaysia, Thailand). The Chinese economy is flying, with an investment rate higher than savings, given that (without a sufficient birth rate and sufficient pensions) households are saving for their elderly years. Chinese savings are now targeting the stock of U.S. securities that have funded the import expenditures of high consuming U.S. households. With high asset prices relative to consumer prices (initially meaning the stock exchange index, then property prices), U.S. households, rationally, have not saved. At the time of the outbreak of the crisis, the U.S. had an import surplus of more than 5% of GDP. The crisis has restored the asset/product price ratio in the U.S., thus increasing savings and reducing the trade deficit, with the Fed's balance sheet growing to a record level (without causing inflation for the time being) and government debt reaching 100% of GDP. Due to the disagreements in Congress, rating agencies are considering the downgrading of U.S. government bonds. In the EU, the crisis has been deeper than in the epicentre. All the problems of a wrong system without a common state and a common currency have surfaced. Japan is slowly recovering from the 2009 decline. China gives more emphasis to domestic infrastructure development, thus the importance of external markets in growth may diminish. The way forward is unclear.

The Hungarian economy

Hungary's GDP grew by 0.3% in the first half of 2011 over the end of 2010. Only Portugal and Slovenia had a lower GDP growth rate in the EU-27. (GDP grew in the first quarter and stagnated in the second quarter). The GDP growth rate, exceeding by 1.5% that in the first half of 2010, resulted from three components: a +0,1% increase in end-consumption, a -1.4% decrease in gross investments and a +2.8% increase in trade balance. The number of those employed grew over a year by 30,000, or 0.8%. The share of those employed in the 15-74 age group was less than 50%. The rate of unemployment decreased by 0.2 percentage points to 10.8%. Real wages grew by 1.4% (the more children in a family, the higher the income). For the first time after many years, real wages in the business sector exceeded those in the public sector (the latter shrinking in the past 12 months). Inflation dropped to 3.1% in July, one-tenth of what it was 15 years ago. Investments grew by 0.7% in the first quarter to declined by 6.5% in the second quarter over the same period in the previous year, resulting in an overall decrease of 4% in the first half of the year. The transport and warehousing sector and the construction sector saw an especially sharp decline of 29.3% and 16.6%, respectively. Significant growth rates were recorded in manufacturing (28.6%), education (15.3%) and, surprisingly, in health care (48%). The figures for external trade can be interpreted in different ways (in the period between June 2010 and June 2011, exports grew by 2.98%, imports by 2.58%). Between 1996 and 2008, exports grew at a monthly rate of 1.15%. At the beginning of 2009, exports feel to two-thirds of the October 2008 level. Then, they took a rapid growth path in the past two and a half years with a monthly trend rate of 1.52% (falling in the last 12 months to 0.25%). The balance of trade has been positive since 2007 as a trend, growing further in 2009. What can be seen by international comparison is that it is quite unusual for the export growth rate to be three or four times that of GDP: in 12 years (1996-2008), Hungary's export-to-GDP ratio rose from 50% to 81%, making Hungary one of those countries with the highest export exposure. For the country to reduce its vulnerability, the growth rate of exports should not exceed four-thirds of that of GDP over the next twenty years. Industrial sales stagnated, domestic sales fell by 4.3%, export sales rose by 2.4% over June 2010. Construction continued to decline: taking 2007 as 100%, it fell to 65% by end-2010 and 60% by June 2011. Agricultural sales and purchases were 2% lower between January and June 2011 than a year before. Hungary's net lending/borrowing rose to +36% of GDP in the first quarter of 2011 as a result of the re-channelling of funds from private pension funds to the state-run pension system. Without this, the result is -6.4% in the first quarter and 4.8% in the second quarter. Households' net savings were at -37.6% of GDP due to individuals returning from private pension funds to the state-run pension system. Without this, net savings would have been at +4.9% and +4.0% of GDP in the first and second quarter, respectively.

The Hungarian banking sector

Total assets at current prices were at HUF 31.724 billion in the sector, 7% lower than in June 2010. The rate of decline in lending (-11%) was nearly double that of the growth in securities (6%). (The share of loans in total assets was nearly double that of securities [59% vs. 25%]). The remaining 15% represented by other items also had a reducing impact on total assets. Total assets in real terms (net of exchange rate effects and inflation) fell by 10% during one year between June 2010 and June 2011, loans dropped by 14%. Corporate loans fell by 13%, retail loans dropped by 9%. The stock of securities grew by 2% (with securities for trading rising by 13%, those for investment decreasing by 9%). During the three-year period between

June 2008 and June 2011, total assets fell in real terms (net of_exchange rate effects and inflation) by 17%, with loans dropping by 29% (corporate loans by 34%, retail loans by 14%) The stock of securities rose by 50% (that of securities for trading by 50%, that of securities for investment by 49%). In contrast to the increase of previous years, **banks'** total assets at current prices fell by 8%, with loans falling more, by 12%. Corporate loans dropped by 11%, retail loans by 6%. The volume of securities rose at current prices by 2%. The share of foreign currency assets in total assets at current prices declined over the past 12 months by 5 percentage points from 55% to 51%. The share of foreign currency loans in total loans fell by five percentage points, from 73% to 68%. After years of steady rise, **retail loans** fell in nominal terms by 5% in June 2011 over June 2010. Here, consumer loans fell more than home loans (by 6%, or HUF 180 billion vs. 3%, or HUF 130 billion). The rate of loans more than 90 days past due (NPL) has increased after 2008. It was **3%** in June 2008, **6%** in June 2009, **9%** in June 2010 and **12%** in June 2011. The stock of **corporate loans** at current prices fell by 11% between June 2010 and June 2011. Loans to large companies dropped by 16%, loans to SMEs by 8% (including loans to micro enterprises falling by 4%, loans to small enterprises by 13% and loans to medium-sized enterprises by 4%). The NPL ratio to total corporate loans was **10%** in June 2010 and **14%** in June 2011 (with a **2%** lower ratio to foreign currency loans in both periods). Banks' **liabilities** declined by HUF 2,309 billion between June 2010 and June 2011, with deposits falling by HUF 221 bilion and debt securities dropping by HUF 364 billion. Interbank deposits declined by HUF 597 billion, loans taken by HUF 703 billion. 90% of the decline of liabilities was due to the decline in direct foreign liabilities. The impairment-to-total classifiable portfolio ratio shows a steady deterioration (the ratio being **2%** in June 2009, **4%** in June 2010 and **6%** in June 2011), although the pace of deterioration has slowed. Unless some unexpected developments occur, the impairment-to-total classifiable portfolio ratio may stabilise at 6% to 7% by the end of the year. The most important **non-annualised** profit figures for the first half of 2011 were as follow: net interest margin was 1.6%, a slight increase over the first-half figures of previous years. Interest paid was 3.6%, unchanged relative to the first half of 2010, interest paid dropped by 0.1 percentage point to 2.0%. Non-interest income (net) was 0.4%, half of the first-half rates posted in previous years. Earnings from commissions and fees were unchanged for the third consecutive year now (0.4%). Dividends (a major part of them from foreign subsidiaries) have shown a steady rise year after year (0.3% in H1 2011). Net profit on financial and investment services was 0.2%, one of the lowest. The -4% in other non-interest earnings is a high rate, given that it now includes the bank tax, which alone was -0.25%. Operating expenses have shown no decrease for three years now. This is due to the decline in banking activity (in previous years, the increase in lending allowed some improvement). Operating expenses were at 1% in the first half of 2011. The change in impairment and provisions was -0.4%. Profit before tax and profit after tax (0.6% and 0.5%, respectively) were the same as in the first half of 2010. ROE in nominal terms was 5.7% in the first half of 2011, just slightly different from that in the first half of 2010, when there was no bank tax. In the past five years, the share at current prices of banks, **branches of foreign banks and cooperative credit institutions** in total assets, respectively, has changed significantly. Between 2006 and 2011, the share of banks in total assets fell by 7 percentage points, that of branches of foreign banks rose by 8 percentage points and that of cooperative banks declined by 1 percentage point.

ANNEX II

INTERNATIONAL DEVELOPMENTS:

REGULATION, SUPERVISION - EUROPEAN BANKING FEDERATION

I. Global developments

I.1 Financial Stability Board (FSB) consultation document - Effective resolution of systemically important financial institutions (SIFIs)

The Financial Stability Board in July published a consultation document on effective resolution of systemically important financial institutions. The document consists of five main parts, including eight chapters (annexes). These are as follows:

Resolution powers and tools

- *Key attributes of effective resolution regimes***.** (This sets out the powers and tools that all jurisdictions' regimes for resolution of financial institutions should have to be effective, including the resolution of cross-border SIFIs).
- *Bail-in within resolution***.** (This sets out proposed essential elements of a bail-in regime to enable creditor-financed recapitalisation of financial institutions).

Cross-border arrangements

- *Institution-specific cross-border cooperation agreements.* (This sets out proposed minimum common elements of institution-specific cooperation agreements between relevant resolution authorities to facilitate resolution of a cross-border firm).

Planning for resolution

- *Resolvability assessments*. (This sets out a proposed framework for assessing the resolvability of a SIFI, taking into account the structure of the firm and the resolution regimes of the jurisdictions within which it operates).
- *Recovery and Resolution Plans (RRPs*). (This sets out a proposed framework and contents of RRPs, which will be mandatory for global SIFIs [G-SIFIs].

Removing obstacles to resolvability

- *Measures to improve resolvability*. (This seeks comment on actions to remove obstacles to resolution arising from complex firm structures and business practices, in particular obstacles that arise from fragmented information systems, intra-group transactions, reliance on service providers and global payment operations).

Discussion notes (reflecting the preliminary views of the FSB)

- *Creditor hierarchy, depositor preference and depositor protection in resolution***. (**This sets out the policy issues surrounding whether or not greater convergence across jurisdictions in the ranking of creditors' claims, in particular in the treatment of deposit claims, is desirable).
- *Conditions for imposing temporary stays*. (This discusses the possible conditions under which a temporary suspension of contractual early termination rights should apply to support implementation of certain resolution tools).

Comments were invited by September 2, 2011. The FSB will revise the documents, taking into account comments received, and will submit them, as part of its overall recommendations to address moral hazard posed by SIFIs, to the G20 Leaders Summit in Cannes in November.

In its response, the **European Banking Federation** highlighted the following key points:

- The establishment of an effective, cross-border resolution framework which allows for firms to be resolved without undue systemic disruption is likely to be the most effective way to addressing the moral hazard problem. The EBF therefore welcomes the overall approach set out by the FSB as an important step forward, while emphasising that the final framework should be as complete as possible and must be consistently applied across jurisdictions.
- The FSB and the G20 should pursue the creation of a harmonised international resolution regime by international treaty within a defined time-table.
- There is still need for a cumulative impact study on the combination of Basel III, the effective resolution regimes of SIFIs and the additional loss absorbency requirement for G-SIBs and other regulatory changes currently being introduced.
- Recovery and Resolution Plans or other measures should not be used for supervisory intervention in the structure or operation of healthy financial institutions without restructuring or resolution having become necessary.
- The trigger for resolution needs to be well defined in advance by law. The trigger mechanism should be set at a high threshold and be as transparent, objective and predictable as possible, however without being automatic based on numerical thresholds.
- There is a need for delicate balance between transparent and acceptable reporting and disclosure for investors while maintaining necessary confidentiality.
- There needs to be legal certainty with regard to the accountability and liability of the institutions and authorities involved in crisis management.
- The home supervisor should draw up and coordinate resolution measures and provide a clear definition of tasks for both home and host supervision authorities. The home supervisor should always serve the cause of global, not merely national, financial stability.
- There should be no unduly burdensome restrictions on intra-group guarantees (or cross-default provisions). At the same time, intra-group financial support should remain a voluntary management decision.
- The suspension of the close-out netting mechanism should be considered carefully following an impact assessment that analyses whether the advantages of a possibility to suspend close-out netting outweigh the disadvantages for risk mitigation and financial stability. If implemented, a suspension of close-out netting mechanism should be subject to strict time limitations.
- The cost of a bank failure should be borne by shareholders and holders of other loss absorbing instruments. Creditors should suffer losses only in exceptional circumstances, equivalent to a liquidation, where all alternative measures have been explored and exhausted. Only subsequently should the wider industry be called to absorb further costs.
- The framework should ensure equitable treatment of creditors and shareholders across home and host jurisdictions and maintain financial stability for all jurisdictions concerned.
- A bail-in statutory framework is a potential resolution tool that needs to be further explored following a thorough impact analysis. If introduced, statutory bail-in should be as flexible and as broad as possible. It should be applicable globally to all financial institutions, and not only to SIFIs. However, the introduction of a bail-in regime should be appropriately timed when markets have returned to business as usual.

The ***IBFed***[4] also expressed its support for the creation of special resolution regimes for financial institutions, to protect society from the costs of failure and to limit the effects of contagion to the financial system as a whole. In its general remarks it pointed out that the need for the preservation and maximisation of going concern values for the benefit of creditors should be a priority and that internationally coordinated reforms of domestic resolution regimes and tools and of frameworks for cross-border enforcement of resolution actions need to be accelerated.
In its letter, the IBFEd provided detailed positions on the issues addressed by the FSB document. These in most cases were similar to those given by the EBF.

I.2 Basel Committee for Banking Supervision (BCBS): Measures for global systemically important banks (G-SIBs).

At its June 25, 2011 meeting, the Group of Governors and Heads of Supervision (GHOS), the oversight body of the Basel Committee, agreed on a consultative document setting out measures for global systemically important banks (G-SIBs). These measures include the methodology for assessing systemic importance, the additional required loss absorbency and the arrangements by which they will be phased in. The document, titled *Global systemically important banks: Assessment methodology and the additional loss absorbency requirement, was* published for consultation at the end of July. It will be submitted to the Financial Stability Board (FSB), which is coordinating the overall set of measures to reduce the moral hazard posed by global systemically important financial institutions. In the document, The BCBS points out that the current policy measures are not sufficient to address the negative externalities posed by G-SIBs. The negative externalities associated with institutions that are perceived as not being allowed to fail due to their size, interconnectedness, complexity, lack of substitutability or global scope are well recognised. The moral hazard costs associated with implicit guarantees derived from the perceived expectation of government support may amplify risk-taking, reduce market discipline and create competitive distortions, and further increase the probability of distress in the future.
The broad aim of the policies is to:

- reduce the probability of failure of G-SIBs by increasing their going-concern loss absorbency; and
- reduce the impact of failure of G-SIBs, by improving global recovery and resolution frameworks (this is also aimed at by the FSB's earlier mentioned consultation document).

The Basel Committee's proposals address the first objective of requiring additional going-concern loss absorbency for G-SIBs, thereby reducing the probability of failure. (The work of the Basel Committee forms part of a broader effort by the FSB to reduce the moral hazard of G-SIFIs).
The Basel Committee has developed an assessment methodology for systemic importance of G-SIBs. The proposed methodology is based on an indicator-based measurement approach**.**
The proposed indicators and their weightings are as follows:

[4]IBFed: International Banking Federation. (Founding members of the IBFed include the American Bankers Association, the Australian Bankers Association, the Canadian Bankers Association, the European Banking Federation and the Japanese Bankers Association. Associate members of the IBFed include the China Banking Association, the Indian Bankers Association, the Korea Federation of Banks, the Association of Russian Banks and the Banking Association of South Africa).

Indicator-based measurement approach		
Category (and weighting)	**Individual indicator**	**Indicator w**
Cross-jurisdictional activity (20%)	Cross-jurisdictional claims	10%
	Cross-jurisdictional liabilities	10%
Size (20%)	Total exposures as defined for use in the Basel III leverage ratio	20%
Interconnectedness (20%)	Intra-financial system assets	6.67%
	Intra-financial system liabilities	6.67%
	Wholesale funding ratio	6.67%
Substitutability (20%)	Assets under custody	6.67%
	Payments cleared and settled through payment systems	6.67%
	Values of underwritten transactions in debt and equity markets	6.67%
Complexity (20%)	OTC derivatives notional value	6.67%
	Level 3 assets (assets whose fair value cannot be determined)	6.67%
	Trading book value and Available for Sale value	6.67%

The Basel Committee proposes to group G-SIBs into five categories (buckets) of systemic importance, based on the score produced by the indicator-based measurement approach and ancillary indicators, providing for additional loss absorbency requirements between 1.0% and 2.5% for the first four categories. For the fifth bucket (initially empty), the BCBS proposes an additional loss absorbency requirement of 3.5% (to discourage banks from material growth). The additional loss absorbency requirement is to be met with Common Equity Tier 1 at the consolidated group level as defined by the Basel III framework. (The Basel Committee is of the view that contingent capital should only be used for meeting national requirements stricter than the global requirements). G-SIBs breaching the additional loss absorbency requirements will be subject to the limitations on dividend payout defined by the conservation buffer bands. The additional loss absorbency requirement will be phased-in in parallel with the capital conservation and countercyclical buffers, i.e. between January 1, 2016 and year-end 2018, becoming fully effective on January 1, 2019.

In its response to the consultation document, the EBF made the following key points:

- The incentives to resolvability should be taken on board in the proposed model.
- The framework should be extended to non-banking financial institutions.
- The assessment methodology should be sensitive to the total systemic risk of the whole sample and not only the relative position within the sample.
- The model should include risk-sensitive measures to complement and improve accounting figures.
- The benefits of diversification should be factored in for the sake of preserving the right incentives.
- Contingent capital should be eligible as a G-SIBs buffer instrument.
- The G-SIB buffer should be established as a distinct range above the capital conservation buffer (7%-9.5%) to avoid the “cliff effect” of the restriction on distributions.

- The activities financed by an affiliate in the country and currency where it is domiciled should be considered local activities and not cross border.
- The nature of the EU single market should mean that intra-EU transactions are not treated as cross-jurisdictional activity.
- Any additional loss absorbency should only be required at the consolidated group level.
- The cumulative impact (on top of Basel III and national rules) remains a major concern, especially in the context of the still fragile economic recovery.
- Additional capital cannot be the only answer. Improved risk management practices and governance are central to systemic risk prevention.

I.3 Outcome of the September 28 Basel Committee meeting

After a careful review of public comments received on the July 2011 consultative document, the Basel Committee agreed to publish the assessment methodology for global systemically important banks ahead of the G20 summit in November. The Committee agreed to retain the proposed calibration for the additional loss absorbency requirement, which will range from 1% to 2.5% Common Equity Tier 1 (CET1) depending on a bank's systemic importance, with an empty bucket of 3.5% CET1 as a means to discourage banks from becoming systemically even more important (that is, larger). The Committee is proposing some changes to certain indicators to improve the methodology for identifying G-SIBs, which will be subject to additional testing by March 2012 using updated bank data. The final regulation is planned to be implemented by January 1, 2016.
The Committee discussed comments on its proposal to introduce capital requirements for banks' exposures to central counterparties (CCPs). These exposures arise in the context of centrally cleared derivative transactions and the Committee believes that appropriate capitalisation is an additional measure to address systemic interconnectedness. The Committee agreed to a number of adjustments to the treatment of banks' exposures to a CCP default fund and will issue these changes for final consultation in the coming weeks.
The Basel Committee also reviewed its work related to finalising the liquidity standards over the observation period and the monitoring of members' adoption and implementation timelines for the Basel regulatory capital framework, which includes Basel II, II.5 (trading book exposures) and III.

I.4 Industry letters to the G20 group

I.4.1 EBF letter to the EU finance ministers attending the G20 forum, on systemically important financial institutions

In relation to the additional capital requirements for G-SIBs, proposed by the BCBS, the EBF offered the following points for consideration by the EU finance ministers ahead of the G20 finance ministers' meeting of October 16:

- A bank resolution framework may be the best solution to prevent contagion, one of the main forms of systemic risk. Crisis resolution agreements between states would reduce the risk of bank failures. Therefore, developing a crisis resolution framework for institutions should have a priority over further increasing capital requirements.
- The EBF has overall concerns about setting additional capital requirements for G-SIBs. The EBF fears that the cumulative impact of the proposed global regulatory reform would jeopardise global economic growth and the proposed surcharge for G-SIBs would be counter-productive in terms of economic growth.

- From the point of view of systemically important financial institutions, the European Union should be regarded as a single market. Intra-EU transactions are not treated as cross-jurisdictional activity and should not be subject to sanctions.

In light of all this, the European banking community requests the G20 leaders to postpone the decision on surcharge or reduce the surcharge to a more prudent level until a holistic framework for systemic risk management is developed.

I.4.2 IBFed letter ahead of the G20 summit in November

The IBFed called on the G20 leaders not to accelerate Basel III adoption and to recommit to the envisaged timetable. The IBFed also has doubts as to the conceptual merit of designating certain firms as being systemically important and imposing additional capital requirements on them. In the IBFed's view, the objectives intended to be delivered can be realised through the adoption of an effective resolution regime. The IBFed also pointed out that the size and complexity of the reform agenda increase the risk that measures will be implemented in an inconsistent manner, undermining the benefits of a globally coordinated regulatory regime and increasing the risk of destabilising regulatory effects. The IBFed drew attention that the regulatory overload blocks business planning and development and thereby undermines current and future economic growth. The G20 leaders should identify the priorities and agree to implementation in a coordinated, consistent and deliverable manner, which is sensitive to the economic environment.

I.5 IIF report on the cumulative impact on the global economy of changes in the financial regulatory framework

This report, published in September, is a follow-up on the IIF interim report published in June 2010. The follow-up takes into account the decisions on the timetable for the adoption of the new regulations and adds estimates on the United Kingdom and Switzerland to those of the United States, the Euro Area, and Japan. While recognising the stability benefits of regulatory reform (higher capital and liquidity requirements, additional taxes, SIFIS, resolution regimes, restrictions on activities) accrued over the long-term, it warns of the near-term costs associated with the proposed reforms. In the IIF's opinion, the official sector studies have tended to downplay the economic growth costs of reform and to overstate its benefits. In the IIF's estimates, the higher lending rates will reduce the level of real GDP by about 3.2 percent over the next five years, or by about 0.7 percent per year, and this would lead to about 7.5 million fewer jobs being created over the next five years than would otherwise be the case. Increased capital needs will lead to an increase in bank lending rates of about 364bps over the next five years. As an adjustment, credit supply will drop. The proposed reforms would further intensify the de-leveraging process, which could add to economic instability. GDP is estimated to fall by 3 percent in the euro area over five years, with 2.8 million fewer jobs. Banks' funding requirements are estimated to increase by EUR 249 billion by 2015 and EUR 563 billion by 2020. Euro lending rates are estimated to rise by 291 basis points over the next five years.

II. EU regulations

II.1 Capital and liquidity regulations (CRR, CRD 4)

II.1.1 European Commission proposal for the regulation of capital and liquidity requirements

Pursuant to the European Commission's decision, the requirements for banking and investment activities will be regulated in the form of a Directive (CRD4) and a Regulation (CRR). These regulations[5] shall apply to credit institutions and investment firms: Directives 2006/48/EC and 2006/49/EC have been merged and the former appendices have been incorporated into the main text. The Directive and the Regulation are to be read together and include the requirements, supervisory framework and prudential requirements for banking and investment activities. The objective of the proposed regulatory framework is to address the deficiencies identified in the light of the financial crisis, including liquidity, the definition of capital (capital quality), counterparty risk, and harmonisation (the removal of national options and discretions).

Licensing (minimum capital requirements), supervisory cooperation and information exchange, the framework for consolidated supervision, including liquidity oversight and the roles of auditors will be regulated by the ***Directive***. (CRD4 reinforces the powers of consolidated supervisors. In home-host disputes concerning capital and liquidity requirements or liquidity subgroup , the EBA[6]'s decision will be binding). New elements in the Directive include provisions on sanctions, effective corporate governance and provisions preventing overreliance on external credit ratings.

Regarding sanctions, the Directive provides administrative sanctions applicable to the key violations of the regulations, the appropriate personal scope and minimum extent of administrative sanctions, and provisions for the publication and reporting of violations. Strengthening *corporate governance* is a priority for the European Commission, especially in the context of its financial markets reform and crisis prevention programme. Objectives include increasing the effectiveness of risk oversight by boards (requirements and restrictions regarding board members, enlarging the pool of suitable candidates), improving the status of the risk management function and ensuring effective monitoring by supervisors of risk governance and remuneration policies discouraging excessive risk taking. In line with the FSB principles, the Directive requires banks to develop and *use internal models rather than relying on external ratings* in determining their regulatory capital requirements. Capital requirements for credit risk and market risk should be based on external credit ratings only to the extent necessary. Where credit risk is material, institutions should generally seek to implement internal ratings based approaches or internal models. Standardised approaches that rely on external ratings could be used where credit risk is less material, which is typically the case for less sophisticated institutions, for immaterial exposure classes, or in situations where using internal approaches would be overly burdensome.

[5] In this section, we use the term "regulation" in the comprehensive sense meaning CRD4 and CRR together, while the term "capital framework" denotes the entire Basel III package, including the liquidity framework.

[6] European Banking Authority

Out of the key elements of Basel III, the Directive includes rules requiring the maintenance of *capital conservation* and *countercyclical capital buffers*.[7] Institutions failing to meet these capital buffer requirements will be subject to restrictions, such as the prohibition of distribution or of variable remuneration payments or of discretionary pension. These institutions shall prepare a capital conservation plan and submit it to the competent authority.

CRD4 should be aligned with the Directive on the reorganisation and winding up of credit institutions and its application should not lead to discrimination among creditors from different member states.

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

Early implementation of provisions of the Regulation will be a national discretion. At the same time, the proposal removes all national options and discretions. Some specific well defined areas, where divergences are driven by risk assessment considerations, market or product specificities and member states' legal frameworks, are exempted, allowing member states to adopt stricter rules. The proposal contains three possibilities for competent authorities to address macro-prudential concerns at national level:

- for lending secured by immovable property, member states could adjust the capital requirements,
- member states could impose additional capital requirements to individual institutions or groups of institutions where justified by specific circumstances under Pillar 2,
- member states set the level of the countercyclical capital buffer.

The proposed Regulation provides a more specific definition of capital, in accordance with Basel III. It includes provisions regarding the criteria for the highest quality own fund and rules for deductions of significant holdings in insurance entities and financial conglomerates, the phasing out of instruments issued prior to September 12, 2010 (grandfathering), the application of the Basel III definition of capital to the highest quality capital instruments issued by non-joint stock companies, such as cooperative banks, the recognition of minority interest and certain capital instruments issued by subsidiaries and the deduction of certain Deferred Tax Assets.

Possibilities for a more favourable treatment of certain exposures will be looked into still before entry into force of the Regulation. The EBA will analyse and report by September 1, 2012 on the current risk weights for SMEs, testing the possibilities for a reduction. (The Commission will review the favourable treatment of SME and retail exposures within 24 months after entry into force of the Regulation). Likewise, the BSBC will, by the end of 2011, review whether more favourable requirements could be set for trade finance.

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

An important lesson learnt from the financial crisis was that Basel II had failed to properly address securitisation and trading book exposures. In line with the BCBS's opinion, the CRR corrects this by providing higher capital requirements or requiring deductions from capital.

The financial crisis highlighted that credit institutions and investment firms massively underestimated the level of counterparty credit risk associated with OTC derivatives. Accordingly, the legislation adopting Basel III addresses these exposures, as well, by allocating a 2% weight to all CCP exposures to promote the clearing of OTC derivatives through central counterparties. (The chapter on counterparty risk complements the Commission's Regulation on OTC derivatives, central counterparties and trade repositories, dated September 15.)

The introduction of *liquidity regulations* is consistent with the relevant requirements of Basel III. The Liquidity Coverage Ratio (LCR) shall be reported from 2013 and applied from 2015. The European Commission has the power to further specify the Liquidity Coverage Requirement in line with the conclusions from the observation period and international developments. The Commission is firmly committed to reaching a minimum standard on the Net Stable Funding Requirement by January 1, 2018. Thus, there would be sufficient time to develop a stable funding requirement in the form of a co-decision proposal to be agreed between Parliament and Council before the end of the observation period. However, institutions will be required to report their NSFRs already during the observation period. Based on the observations and supported by EBA, the Commission should confirm or adjust the liquidity coverage requirement by means of a delegated act. The liquidity requirements will apply on an individual and consolidated basis, unless the competent authorities by joint agreement disapply supervision on an individual basis where they deem this appropriate. (Where no agreement has been reached by the competent authorities, each competent authority responsible for supervision on an individual basis shall take its own decision).

In line with Basel III, there will be no mandatory leverage ratio requirement in the initial stage. The proposed non-risk based leverage ratio will subject to an observation period from January 1, 2013 to January 1, 2017. Institutions should disclose their leverage ratios from January 1, 2015 and the leverage ratio is expected to be introduced as a binding requirement from 2018, based on appropriate review and calibration. Credit institutions and investment firms should during an observation period monitor the level and changes in the leverage ratio as well as leverage risk as part of the internal capital adequacy assessment process (ICAAP) under Pillar 2 and its should be monitored in relation to the different business models.

The CRR extends the Basel I capital floor of 80% until 2015. Competent authorities may, after consulting the EBA, waive the application of the Basel I limit to an institution provided that all requirements for the use of the advanced approaches for credit and operational risks are met.

While providing for minimum capital requirements, the proposed regulations seek to provide appropriate incentives for credit institutions and investment firms to move towards the more risk-sensitive (advanced) approaches. Accordingly, the development and validation of risk assessment and measurement models should be ensured. However, the use of a simpler measurement approach in itself should not entail more stringent supervision. Based on the principle of proportionality, the simplest possible rating procedures will be recognised for retail exposures. The CRR allows for better recognition of credit risk mitigation techniques (including under the standardised approach).

The new regulation also addresses the powers of the European Commission and the European Banking Authority (EBA). The European Commission shall be responsible for implementation of the capital requirements framework, ensuring consistent conditions for implementation and the provision of clarifications regarding the definitions and terms in respect of activities subject to mutual recognition, specified in the annexes. The Commission will also be responsible for drafting the implementing and delegated acts and submitting them to Parliament and Council in due course. The EBA will be responsible for submitting regulatory and implementing technical standards for adoption by the Commission. Information exchange between regulators will be conducted through the EBA.

According to the impact assessment published simultaneously with the Commission's proposal, the regulatory package and CRD 3 together are estimated to increase the RWA of Group 1 (large) banks by 24.5% and the RWA of Group 2 (small) banks by 4.1%. The additional funding requirements needed to meet the new minimum requirement and the capital buffers are estimated at EUR 84 billion by 2015 and EUR 460 billion by 2019. The analysis implies net economic benefits of an annual increase in the EU GDP in the range of 0.3%-2%, due to the reduced probability of future financial crisis.

II.1.2 EBF positions

II.1.2.1 High-level letter to the Polish presidency and the EU rapporteur

In this letter, the EBF expresses its intention to cooperate with a view to drafting a regulation that strikes appropriate balance in relation to financial stability and growth. The EBF considers that the following key principles should be followed in drafting the regulation:

- *The cumulative impact of the new measures cannot be ignored*
  Although a number of impact studies have been prepared (Basel III, ex-ante funded deposit guarantee schemes, bank taxes, additional capital requirements for SIFIs, clearing of derivatives through CCPs, cross-border crisis resolution), the cumulative impact of the proposed measures has not been assessed. A research would be needed on the banking sector's ability to finance economic recovery under the proposed regulatory framework. Therefore, it is surprising that the proposal allows national supervisors to adopt the new requirements within a shorter timetable, disregarding the phasing-in arrangements of Basel III. (The FSB and the BCBS are of the view that early introduction of the new capital requirements would have a negative impact on GDP and growth).
- *The competitive position of the European industry should not be put at risk*
  The introduction of Basel III would entail more adverse consequences in Europe. Therefore, the Basel package should be transposed in a flexible way by taking account of European specifics. The EBF objects to CRD4 containing elements that would not just be introduced early but would also be more stringent than Basel III. The EBF has also doubts regarding the timely introduction of the Basel accords (Basel II, Basel II.5, Basel III) in the United States. Therefore, it considers that the review provisions, currently applicable to remuneration policies, should be extended to other provisions of the Directive and the Regulation.
- *CRD 4 should refrain from creating new competitive distortions across the EU*
  The EBF strongly supports the development of a single rule book and agrees that a regulation and an EBA technical standard would be the best tools for this. However, it

also agrees that, due to national specifics, mortgage lending should not be part of the single rulebook.

- *The new liquidity framework should be tested*
  The EBF welcomes the intention to use the observation period for testing. However it objects to the fact that the proposed European legislation, going beyond Basel II, only recognises central bank eligible instruments as liquid instrument.
- *An appropriate timetable should be set for implementation*
  The EBF stresses the importance of providing for appropriate grandfathering rules and draws attention to difficulties arising from the extension of the Basel I floor.

II.1.2.2 EBF comments to the European Parliament on CRD4

In its letter to the EU rapporteur, the EBF reiterated and explained in detail the three key principles presented in its high-level letter. In its letter to the Rapporteur, the EBF sought to confine the number of issues, but with little success: it highlighted 26 issues in four key areas, as follows:

Liquidity

1. The EBF points out that the observation period should be used not only to examine how the requirements will impact on the liquidity resilience of banks but also to understand the impact of the proposed metrics on the economy. The proposed liquidity requirements may heavily impact lending to SMEs, lending to municipalities, trade finance and activities requiring investments, such as commercial paper issuance and investment in corporate bonds.
2. The definition of liquid assets should not be carved in stone at this stage of the process.
3. In relation to intra-group liquidity, the EBF proposes that the waiver of the application of the Liquidity Coverage Requirement on a legal entity basis should be extended and that regulators should be required to apply a symmetric treatment regarding intra-group transactions.
4. The EBF does not support the 75% cap on inflows. This restriction has been brought up quite late in the discussions and in the EBF's view it is not justified from a prudential standpoint, either at the consolidated level, or at the solo level.
5. Deposits from corporates within the framework of an established relationship should be multiplied by 25% rather than by the proposed 75%.
6. In relation to undrawn facilities, the EBF objects to the undifferentiated treatment of uncommitted and committed lines as additional flows. Further, it considers the 100%-os outflow in both cases draconian.
7. The EBF proposes that the definition of retail deposits in the case of SMEs should be based on turnover criteria rather than the size of deposits.

Own funds

1. In determining Common Equity Tier 1 capital, the "substance-over-form" approach should be decisive.
2. The treatment of investments in insurance companies in accordance with the Financial Conglomerates Directive as a rule should be an obligation rather than a national discretion.
3. Regarding the recognition of minority interests, the EBF considers that the minority interests to be included in the capital base on a consolidated group level should be the amount of the relevant capital requirement that relates to the

subsidiary when calculating the capital requirements of the group on a consolidated basis or the comprehensive local regulatory requirement on a stand-alone basis if it is higher.

4. The EBF is of the view that the write-off or conversion of instruments into Common Equity Tier 1 capital at the point of non-viability of the institution should be addressed within the context of the proposed legislation on bank resolution.
5. The EBF proposes introducing a regulatory adjustment which would exempt EU banks from deducting software from regulatory capital until a consistent treatment is effective on a global level.
6. The transitional provision prolonging the Basel 1 floors until 2015 is a major concern in several respects. Supervisory discretion to provide exemption from the floor is detrimental to a level playing field.
7. The EBF objects to allowing national supervisors to implement the capital requirements within a shorter timeframe, disregarding the phasing-in arrangements of Basel III.

Leverage ratio

The EBF does not support the proposal to transform the leverage ratio into a binding measure in 2018, as this would contradict the provision that from January 1, 2013 to June 30, 2016, the EBA shall conduct a detailed impact study assessing the adequacy to impose a binding leverage ratio in the Pillar 1, or to keep it as a Pillar 2 monitoring tool. The EBF is also concerned about the approach to introduce the "risk of excessive leverage" as an additional risk category under Pillar 2.

Other issues

1. The EBF is concerned about the introduction of a substantially widened mandate in Pillar 2 for national supervisors to impose capital surcharges on individual institutions or groups of institutions.
2. In relation to the risk weights applicable to exposures to institutions, the EBF recommends the maintenance of the central government risk-weight based method for all institutions (Option 1).
3. The principle of reducing overreliance on external credit ratings does not necessarily imply that banks that are currently under the Standardised Approach should migrate to the IRB Approach. This would be particularly burdensome for less sophisticated institutions and against the principle of proportionality.
4. The EBF proposes retaining the 180 days discretion for the definition of default under the IRB approach for retail exposure secured by mortgage.
5. In relation to Credit Value Adjustment (CVA), where most counterparty exposures are held to maturity, the EBF would prefer the external rating approach rather than the market-based CVA approach proposed by the Basel Committee. The impact of CVAs should be carefully analysed by the European Commission in collaboration with the EBA.
6. The EBF proposes providing banks with more flexibility in developing their internal models in determining the Incremental Risk Charge.
7. Excess of provisions in relation to regulatory Expected Loss should be allowed to be recognised in meeting the counter-cyclical buffer requirement.
8. In relation to delegated acts, the regulation confers too broad powers to the European Commission which are too broad.

9. The EBF considers that the capital requirements in respect to SME-loans are too high. Therefore, it supports the review of the applied weights within 24 months from entry into force of the regulation.
10. According to the EBF, the provisions on large exposure need to be adjusted in several points.
11. In relation to corporate governance, the EBF is of the view that the Directive should await the outcome of the relevant public consultation and only provisions that are specific to financial institutions (such as remuneration policies as those are linked to risk management policies) should be part of CRD4.

II.2 Investor Compensation Scheme Directive

The Hungarian presidency handed over the issue of proposed amendments to the Investor Protection Directive to the Polish presidency according to the following status:

- The coverage level is EUR 30,000, higher national compensation levels may remain in place.
- Member states have divergent views regarding the funding of the schemes. To solve the differences, the presidency proposes the introduction of payment commitments. These would combine the advantages of ex-ante financing (security) and ex post financing (the investment firm benefits from interests).
- A number of member states consider the target fund level to be too high. According to the compromise proposal, the target level should be 0.5% of the assets covered and 0.05% of the assets managed by the investment firm.
- Given that almost all member states were opposed to the mandatory lending between national compensation schemes, the presidency made a proposal for voluntary lending.
- Further discussions between member states are needed on the potential extension of the scope of the Directive (investment firms not licensed to hold customer assets, customers investing in UCITS, bankruptcy of external custodians) and on partial payout.

II.3 Report of the U.K. Independent Commission on Banking (ICB)

The recommendations of the newly set up Independent Commission on Banking address three areas: retail ring fence, loss-absorbency and competition. Pursuant to the recommendations, retail banking activities should be conducted in separate (ring-fenced) subsidiaries. Ring-fenced banks should be separate legal entities, meeting the capital, liquidity, financing and large exposure regulations on a solo basis. They should have independent boards and could maintain links in terms of operations and supporting services with the rest of the group. Agency arrangements within the group would allow ‘one-stop’ relationships for customers who required services both from the ring-fenced bank and the rest of the group. Ring-fenced banks with a ratio of risk-weighted assets (RWAs) to UK GDP of 3% or more should be required to have an equity-to-RWAs ratio of at least 10%. Ring-fenced banks with a ratio of RWAs to UK GDP between 1% and 3% should be required to have a minimum equity-to-RWAs ratio set by a sliding scale from 7% to 10%. All UK-headquartered banks and all ring-fenced banks should maintain a Tier 1 leverage ratio of at least 3%. All ring-fenced banks with a RWAs-to-UK GDP ratio of 1% or more should have their minimum leverage ratio increased on a sliding scale (to a maximum of 4.06% at a RWAs-to-UK GDP ratio of 3%). In resolution, banks should issue bail-in bonds and maintain regulatory capital and bail-in bonds amounting to at least 17% of RWAs. A further loss-absorbing buffer of up to 3% of RWAs

should be required of these banks if the supervisor has concerns about their resolvability. The ICB has recommended that the U.K. government enact reform measures, including the ICB's recommendations, soon. Implementation should however be completed at the latest by the Basel III date of the start of 2019.
The ICB's recommendations regarding competition address the issues of market structure, barriers of entry, bank switching and transparency. Progress in improving competition should be reviewed in 2015.

III. European Banking Authority (EBA)

III.1 Consultation papers on the collection of data regarding bank remuneration policies (CP 46, CP 47)

An amendment to CRD3, effective from January 2011, requires national supervisors and the EBA to collect two types of remuneration information: aggregate quantitative information on remuneration, broken down by business area, and information on the number of individuals per credit institution in pay brackets of EUR 1 million and upwards. To achieve this, the EBA proposes a common approach and common reporting templates. (The consultation ran until September 2, 2011).

In its response, the EBF emphasised the need for the EU to seek global solutions. It also pointed out that the EBA's proposed guidance in several points contradicted CRD4, currently being drafted. It also drew attention to the importance of ensuring sufficient time for preparations and the anonymity of data (institutional and personal).

III.2 Guidelines on Internal Governance (GL 44)

Article 22 of Directive 2006/48/EC provides that every credit institution shall have robust governance arrangements, which include a clear organisational structure with well defined, transparent and consistent lines of responsibility, effective processes to identify, manage, monitor and report the risks it is or might be exposed to, adequate internal control mechanisms, including sound administrative and accounting procedures, and remuneration policies and practices that are consistent with and promote sound and effective risk management.
The EBA's guidelines, published following a public consultation, reaffirm and provide a comprehensive set of guidelines regarding supervisory requirements on internal governance. A survey undertaken by the CEBS in 2009 on the implementation of its Internal Governance Guidelines identified a number of gaps in supervisory board functions, risk management and internal control. Based on the results of the survey, the EBA has consolidated, complemented and updated its High-Level Principles on Remuneration published in April 2009 and High Level Principles on Risk Management published in February 2010.
The first chapter of the guidelines addresses issues related to corporate structure and organisation, describing in detail the role of checks and balances in a group structure and the know-your structure principle. The second chapter addresses the composition, appointment and succession of members of the management body, the qualifications of members, with increased focus on the use of committees and the identification and management of conflicts of interest. The third chapter provides high-level principles on risk management. The fourth chapter addresses internal control, including the role of the Chief Risk Officer and the risk management function. The fifth chapter contains new guidelines on information and

communication systems and business continuity management. The sixth chapter, addressing transparency, contains the chapter entitled Public Disclosure and Transparency from the former CEBS Internal Governance Guidelines, with some minor amendments.
Competent authorities shall implement the guidelines by March 31, 2012. After that date, competent authorities should ensure that institutions comply with them effectively.

III.3 Questions and Answers regarding CRD Article 122a

On December 31, 2010, the Committee of European Banking Supervisors (CEBS) published its Guidelines to Article 122a of the Capital Requirements Directive, aimed to promote supervisory convergence. In these Guidelines, the CEBS provided interpretations regarding the retention obligations of originators/sponsors, due diligence and risk management requirements for investors in securitisations. Following the publication of the guidelines, the EBA received a number of questions from competent authorities and market participants, requesting clarification on the guidelines or further guidance on Article 122a. To ensure consistent interpretation, the EBA issued a Q&A paper to encourage market participants to create a more transparent and uniform securitisation market and to enable more convergence of supervisory practices across Europe with regard to Article 122a of the CRD. The questions and answers are categorised in a clear and transparent way by issue.

IV. European Banking Federation (EBF)

IV.1 Other CRD issues

IV.1.1 CRD3 revision

The EBF president wrote a letter to the EU Commissioner on Internal Market, asking for the postponement of CRD3 (Directive 2010/76) implementation. This would be necessary due to the fact that U.S. regulators are unable to implement the tightened Basel II.5 rules for trading book items and securitisation on time due to the Dodd-Frank Act. Consequently, if Europe insisted on the envisaged timetable, European banks would be put at a competitive disadvantage, as the tightened capital requirements would significantly impact institutions' market making capacity. If CRD3 is implemented, European banks will have no choice but to cut back on their sovereign bond and securities inventories. This may lead to the politically delicate situation of European bond trade being concentrated in the hands of foreign banks from 2012. Therefore, the EBF offers for consideration the activation of the review clause, (wisely included in the CRD3 text), to formally evaluate the developments regarding Basel II.5 implementation in the U.S.

IV.1.2 Principle of proportionality

According to the European Banking Federation, the principle of proportionality will be a key issue in the coming period, in particular in the context of the single European rule book. The EBF needs to develop a position on the issue. To achieve this, the EBF published two documents for consultation. One document analyses the CEBS's interpretation and application of the principle of proportionality, the other document reflects on the proposals made by the

umbrella federation of the Belgian financial sector, FEBELFIN, on the practical application of the principle of proportionality.

IV.1.3 Treatment of European Asset Backed Securities under Solvency II

The relevant provisions of the proposed Solvency II framework on capital requirements for insurance companies, currently being shaped, project an unfavourable treatment of European asset backed securities, in particular, of residential mortgage loan backed securitisations. The EBF informed the European Commission of its support of the proposal of the Association for Financial Markets (AFME) for a more favourable treatment.
In its response, the European Commission said it might revise its proposals based on future market data. However, it would probably not adopt the proposals made by the AFME, as those are too complex and would excessively segment securitised assets.

IV.1.4 Pillar 3

The Financial Stability Board is organising a round table discussion in 2012 on disclosure requirements. The document prepared for the discussion well illustrates the shift that has taken place with regard to the contents of Pillar 3. While the original objective in Pillar 3 was to present the risks captured under Pillar 1, by now the emphasis has shifted to the comparability of the disclosures. The EBF's competent working group supports the revised new Pillar 3: although more restricted, it is more useful for authorities and market players and less extensive and thus, less burdensome to prepare.

IV.1.5 Risk Assessment Working Group set up

The EBF Banking Supervision Committee agreed to set up a Risk Assessment Working Group (RAWG). The reason for setting up this working group was that following the definition of capital elements, the right calibration of risk weights (the denominator of the capital adequacy ratio) will be of key importance. The Basel Committee's Standard Implementation Group is giving increased attention to the risk assessment methodologies used for estimating the capital requirements. The RAWG will provide technical support to the EBF in the international discussions related to risk assessment and measurement.

IV.2 EBF letter on the Deposit Guarantee Schemes Directive

In August, the EBF wrote a letter to the Commission, the Council and the Parliament regarding the Deposit Guarantee Schemes Directive, expressing its support of the proposal to set the target level for ex-ante funds at 0.5% of covered deposits. The EBF also welcomes the proposal to allow alternative financing forms, including the meeting up to 10% of the ex-ante funding requirement with payment commitments and assets provided as collateral. However, it considers the 10% limit too low and proposes to raise it to 30%-50%, in particular if the ex-ante target fund level is still set higher. The EBF strongly objects to the minimum annual contribution of 0.1% of covered assets. While the EBF agrees that quick compensation is important, it does not consider the five or seven-day timeframe proposed by decision-makers practicable: reducing the current 20-day deadline would imply increased risks for the institutions involved (deposit guarantee schemes, supervisors). The proposed EUR 5,000

provisional payout would cause banks difficulties in terms of costs and manual work. (If provisional payout is insisted on, the EBF proposes it to be a maximum EUR 2,000).
The EBF gives special importance to the principle of fair contributions to the funds. It does not consider membership in institution protection schemes to be an appropriate criterion for a reduced contribution. It is the EBA's responsibility to determine the methods for contribution payments by taking into account risk-based and non-risk-based factors. In the EBF's opinion, the decision on whether the DGS's assets can be used for early intervention on crisis resolution should remain a national discretion. The EBF reiterates its proposal for authorities to undertake a comprehensive impact assessment on the complex regulatory package (capital, liquidity, deposit guarantee schemes, capital surcharge for SIFIs, reorganisation funds, bank tax).

IV.3 EBF press release on the proposed Financial Transaction Tax

The EBF calls for further dialogue over the proposal put forward by the European Commission in September for the introduction of a Financial Transaction Tax. European banks are of the opinion that the introduction of a financial transaction tax is a nonsense, as it could shift business to elsewhere in the world, with negative impacts on the funding of the European economy and on employment. A Financial Transactions Tax would also have an impact on the liquidity of instruments at a time when any additional cost on funding would be better avoided. European banks insist that the evaluation of the proposed measures should be discussed with the industry prior to their potential adoption. The EBF stresses that legislators should carefully look at ways to prevent such a tax from seriously damaging the European economy.

IV.4 EBF response to the European Commission's proposal for the recapitalisation of banks

In response to the European Commission's statement of October 12 on the recapitalisation of European bank, the EBF turned in a letter to the President of the European Commission and the President of the European Council. (Copies of the letter were sent to the president of the EBA, the competent EU Commissioners, the representative of the Polish presidency and the Governor of the ECB). The letter points out that according to the last stress test, the capitalisation of European banks is strong, with a capital adequacy ratio relative to core tier 1 capital of 8.9% as of the end of 2010. While the capital position of some banks may need to be strengthened, this cannot be done without restoring confidence in banks in member states. Accordingly, member states should negotiate a solution that minimises uncertainty, limits intervention into competition and takes account of the expected economic impacts.
In the EBF's view, a new stress test by the EBA to determine banks' capital needs based on the market value of sovereign debts may have a negative impact. Such a test would overstate the potential losses even by the most conservative scenario. It is a question whether banks would be able to raise the capital required under the current uncertain market conditions. Making available the required capital from government resources would question the commitment to stringent budget policy.
Banks apply the current legal requirements. They cannot be held to account for future capital requirements. Accelerating the tighter requirements may lead to banks adapting by reducing the denominator (that is, lending capacity) rather than increasing the numerator of the capital adequacy ratio.

The EBF drew attention to the problems in the proposal also in a press release, saying it was high time for a coordinated solution to settle sovereign debts.