MAGYAR BANKSZÖVETSÉG

HUNGARIAN BANKING ASSOCIATION

REPORT

on Activities of the Hungarian Banking Association

2nd Quarter 2012

Budapest, August 2012

Contents

Executive Summary

The domestic and international operating environment of the Hungarian banking sector continued to be adverse in the second quarter of the year. GDP in the eurozone is expected to shrink by 0.3% in 2012. Even more importantly for Hungary, in addition to the PIGS countries, the German and French economies are also expected to slow. Hungary's GDP continued to fall in the second quarter, the rate of decline in 2012 is expected to be at or even exceed 1%.

Banks' assets and loan portfolios are decreasing. Total assets fell by 1.4% in nominal terms between March 31, 2011 and March 31, 2012. The net stock of loans dropped by 2.4%, corporate and retail loans declined by 2% and 6.9%, respectively. The decline in the stock of loans in real terms, net of inflation and exchange rate changes, was significantly higher, 1% monthly, for the fourth consecutive year. ROA in the banking sector was negative both in Q3 and Q4 2011 and Q3 and Q4 2012. Due to the Early Repayment Scheme, banks' annualised ROE was -50% in Q4 2011 and -9.7% on an annual basis in 2011. Banks operating as joint stock companies posted a loss of HUF 281 million in Q2 2012. Q2 profits in the sector were significantly lower than in Q1: as opposed to a HUF 37.7 billion profit after tax in Q1, the sector sustained a HUF 30.4 billion loss in Q2. PSZÁF's analysis on Q2 2012, published in August, reveals that the deterioration in banks' assets has not reached the nadir.

A major government measure affecting banks in the second quarter of 2012 was the drafting of legislation on a financial transaction levy, to be imposed from 2013. The government announced its plan to impose this new tax in early April, setting tax rate at 0.1%, with no cap. It was also made clear, that as opposed to the EU concept, where the tax is mainly aimed at investment products, the proposed financial transaction levy would be imposed on payments. The negotiations with the financial government on the proposed tax started by a meeting on May 8 between the responsible State Secretary of the Ministry for National Economy and the Association's Board. The objective was to make the burden manageable for the sector, while we reiterated that the financial transaction levy would harm the economy and hamper growth. As a result of the negotiations, a tax cap of HUF 6,000 was achieved and the scope of the tax was amended to exclude payment transactions related to lending and investment services, interbank transactions, and, partially, cash-pools.

The Act on Financial Transaction Levy was passed by Parliament on July 9. The revenue estimate from this tax is HUF 240 billion, of which 140 billion is expected to be collected from the banking sector.

As a major development in the second quarter, the amended Exchange Rate Cap Scheme with improved terms and conditions for customers opened up on April 2. Although they had a short time to prepare for receiving the customers (split into three groups), banks were able to ensure all the necessary conditions by the set deadline. Pursuant to the relevant legislation, banks were required to notify all customers with more than 90 days in arrears of the option to convert their debt into HUF or to offer (subject to certain conditions being met) their mortgaged homes for purchase by the National Asset Management Company in agreement with their creditor banks. The process started at a slower pace than expected, due to the delayed adoption of the legislation on the National Asset Management Company (with improved conditions for customers). The National Asset Management Company is expected to start the administrative processes in the third quarter, and the number of customers availing themselves of this option is expected to increase. Another challenge for banks was preparing for the implementation of the government's Home Protection Plan and the administration of subsidised home loans.

A new milestone in Hungarian banking was the implementation and testing of the new intraday settlements system, enabling go-live of the system on July 2. Under the intraday settlements system, payments are now executed within a maximum 4 hours and the system of direct debits has been improved.

The Association has long advocated for the setting up of a comprehensive credit information system, which is equally in the interest of banks and customers. The legislation on Central Credit Bureau was adopted in

2011, requiring and regulating the upload of data into the system. The upload of positive data (performing retail loans) into the system was carried out by the deadline provided by law:

- 8.2 million data were uploaded, including the re-entry of 1.7 million previously negative data. The 8.2 million data belong to 4.2 million natural persons.
- With an additional 1.3 million corporate loan data, the Central Credit Bureau currently contains a total of 9.5 credit data.

With the completion of the upload, the project has been concluded. The availability of comprehensive credit information will contribute to increasing lending security.

In addition to the economic situation, the sector's short and long-term operational conditions were significantly influenced by changes in the domestic and international regulatory framework. Main regulatory changes affecting the sector:

- the new Civil Code (the draft law was presented to Parliament on July 11);
- significant changes are expected in the bankruptcy laws once the legislation under drafting is finalised and adopted.

Main developments in the area of prudential regulation in the second quarter included the following:

- PSZÁF issued a recommendation on the treatment of underlying exposures under the large exposure rules.
- PSZÁF published for consultation a proposed methodology guide for recovery plans.
- An amendment to the Government Decree on liquidity coverage requirements for credit institutions and on the maturity mismatch of foreign currency positions of credit institutions was enacted.
- The Ministry for National Economy, MNB and PSZÁF published for consultation a joint concept for the treatment of general provisions in accordance with Basel III.

Another important task in the past period was FATCA compliance. Compliance with the U.S. Foreign Account Tax Compliance Act (which has been amended several times to take account of comments from market players) is a requirement for Hungarian banks as well. However, a number of the FATCA's provisions conflict with Hungarian laws. These obstacles should be removed by the entry into force of the FATCA next year. It is important for Hungarian banks to be able to comply with the FATCA with the minimum possible burdens. To achieve this, we proposed to the Ministry for National Economy that an agreement be concluded at the government level with the U.S. authorities and the responsible Hungarian government agencies initiate an agreement with the U.S. Treasury and the IRS for Hungary to become an FATCA Partner.

Data protection was also a key issue addressed in the second quarter. The Privacy Act contains a new provision requiring banks and insurance companies to register with the National Authority for Data Protection and Freedom of Information. Partly as a result of consultations with the data protection authority (in conjunction with the Association of Hungarian Insurance Companies), banks were able to meet their statutory obligations in a timely fashion.

European prudential regulation is a focus issue from the point of view of the long-term operation of the Hungarian banking sector. A key element of this is the adoption of the regulatory package related to Basel III implementation (CRD4/CRR). The discussion of the proposed compromise text by the Commission, the Council and the European Parliament, which began in the summer, was postponed by September. Accordingly, the adoption of the regulation, originally planned for the end of June 2012, will be delayed and the implementation date may be postponed to January 1, 2014.

The European Commission published its proposal for a Directive establishing a framework for the recovery and resolution of credit institutions and investment firms on June 6, 2012. The proposed Directive would be applied to all credit institutions and investment firms, and shareholders and unsecured creditors would also be involved in the resolution.

As another important development in international regulation, the Basel Committee on Banking Supervision published a consultation paper on a fundamental review of the trading book capital requirements. The consultation paper proposes to strengthen the capital requirements for trading book exposures.

1. The world economy, the Hungarian economy and performance of the Hungarian banking sector

1.1. The world economy

The global growth forecasts of 3.5% and 4.1% for 2012 and 2013, respectively, do not significantly vary from the 3.45% average of the past 30 years. However, these growth rates fail to provide sufficient information as to the enormous challenges the world is to face in the decade ahead.

GDP in the eurozone is expected to shrink by 0.3% in 2012. The biggest decline in GDP is expected in the PIGS countries: 4.7%, 3.3%, 1.9% and 1.8% in Greece, Portugal, Italy and Spain, respectively. The lowest decrease is forecast for Cyprus, Slovenia and Luxemburg, while Germany and France are expected to grow by 0.6% and 0.5%, respectively.

Since 1870, GDP in the U.S. has grown, with minor variations, by an annual rate of 1.87%. Meanwhile, the U.S. government debt has grown at a significantly faster pace. The depth of financial intermediation has grown, facilitating innovation and growth. Between 1954 and 1994, industrial companies' liabilities-to-assets ratio rose from one-third to two-thirds, their ROE grew by 4% to 5% and their assets-to-equity ratio doubled. As the depth of financial intermediation grows, the loans-to-assets ratio will necessarily rise to 70%. This happens at the point where the capital-to-production ratio is 2.5%; if the capital-to-production ratio is above 3%, there is still a couple of years to go. The world's largest economy must substitute the innovative and growth stimulating impact of loans, for example, by opening up its economy.

The stock of loans in the rest of the world has grown faster than GDP at current prices, although the limit seems to be farther. In addition to their own output, growth in the technological-follower countries depends on their ability to adopt the technologies applied in the advanced economies. Those countries with lagging economies but with institutions capable of adopting modern technologies have advanced rapidly in the past one and a half decade. 150 years ago, Japan's and Finland's GDP per capita were one-third of that in the U.S. Today, their lag is only 30%. Hungary has not been able to close the gap at this rate: its GDP per capita has remained at one-third of that in the U.S during the past 100 years. The UK has lost its edge: its GDP per capita is two-thirds of that of the U.S.

The deepening of the international division of labour may be a new growth driver in the U.S. The USA export-to-GDP ratio in the U.S. rose from barely 5% in 1960 to 13% in 2008. Over the past 30 years, global GDP has grown at a rate of a quarter of export growth. A part of the countries, such as the U.S. and other off-shoot countries, the former EFTA countries and the Latin-American countries, have been economically much less open compared to their state of development and population. The closedeness of the U.S. economy has decreased. China, Japan, the South-East Asian countries, the founding countries of the former Common Market and the post-socialist countries have grown rapidly in terms of export-to-GDP ratio. Trade growth slowed significantly in the developed world in 2012, with exports and imports declining by 2.3% and 1.8% respectively. In the developed countries, the rate of slowdown was smaller.

While the ratio of government debt to GDP stagnated or decreased in the developed world and the post-socialist countries between 2000 and 2008, it has risen rapidly in many countries after 2008. Public debt has grown by 45% on average in the PIGs countries (by in 64% in Ireland, 52% in Greece, 36% in Portugal and 28% in Spain). It rose by 38% in Japan, 31% in the U.K. and 27% in the U.S. The indebtedness of the post-socialist countries is low and has not increased over the past decade, except in Hungary. Overcoming indebtedness is more difficult at times when inflation is low. (Inflation in the developed countries is forecast at 1.9% and 1.7% for 2012 and 2013, respectively, consistent with the low GDP growth rate and cheap imports from China). The inflation rate in the developed countries is projected at 6.2% and 5.6%, respectively, in line with a higher GDP growth rate. The reduction of debt through the reduction of inflation is currently not possible. The other tools available would certainly hurt, while there is no evidence for their effectiveness.

Ill-managed debt can explode, as was the case in Greece, whose CDS spread jumped from 1000 to 10000 bps over a year, pushing the country into bankruptcy. The higher a country's debt-to-GDP ratio and the lower its GDP per capita, the higher its CDS spread compared to the reference country's CDS. In the case of two countries with similar debt ratios, the CDS spread of the country of half the wealth was 7 times that of the other country in 2011 and 2012. In highly indebted and relatively undeveloped countries, a high CDS spread my lead to uncontrollable developments. The objective is to identify those tools that are suitable to manage the debt.

1.2. The Hungarian economy

We have looked into the development of competitive factors in Hungary, the European post-socialist countries and the developed EU countries in the past quarter, past year and past decade.
The employment rate in Hungary is low (49.5%), as was the case 10 years ago (56.2%). Hungary has one of the lowest employment rates in the EU.
The ratio of investments to GDP is surprisingly low (16.8%) and the average pace of growth of investments in the past decade has not only been slow, but also negative (-0.16%). Exports, previously growing rapidly, have fallen, while those in the competitive post-socialist countries are growing.
The stock of loans has started to grow rapidly in the post-socialist countries after the crisis. In Hungary, it has fallen slightly in nominal terms and significantly in real terms, in both the corporate and retail segments.
Hungary's government debt is especially high compared to revenues. Consequently, Hungary's CDS spread and government bond yields are high as well.
The „no jobs - no capital - no market" situation, with a high debt compared to revenues, high CDS and poor country ratings in the absence of a (trust building) IMF loan shows that the Hungarian economy has not been able to develop during the past decade at that pace its revenue position would have allowed (the lost growth potential was 1% annually). There is no question that GDP will decrease in 2012. The question is whether the decreased will be 1% or 2%. The more distant the IMF agreement, the closer we get to a 2% GDP decrease in 2012 and the farther from an economic pick up (amidst 2013's "global perfect storm", as Roubini puts it).

1.3. Performance of the banking sector

Banks' asset and loan portfolios shrank (to a less extent in nominal terms and more in real terms), generating increasingly less profits.
Total assets fell by 1.4% in nominal terms between March 31, 2011 and March 31, 2012. The net stock of loans dropped by 2.4%, corporate and retail loans declined by 2% and 6.9%, respectively. The stock of securities decreased significantly, by 6.9% in 2012. The decline in the stock of loans in real terms, net of inflation and exchange rate changes, was significantly higher, 1% monthly, for the fourth consecutive year.
ROA in the banking sector was negative both in Q3 and Q4 2011 and Q3 and Q4 2012. Due to the Early Repayment Scheme, banks' annualised ROE was at -50% in Q4 2011 and -9.7% on an annual basis in 2011. In the first quarter of 2012, banks' ROE was at +5%.
As for profitability, as a trend in the past ten years, the decrease in net interest income was offset by the decrease in operating expenses (the balance of the two being 0.74%) , while net non-interest income (commissions, dividends, investments) was close to 2% of total assets. This was reduced by the bank tax (reported under other net non-interest income), reducing total assets by 0.45% in 2010-2011-2012, while the change in impairments and provisions was 1.4% on average in the same period.
Banks' ROA=2,57% was well plannable over the past ten years by using the change in impairments and provisions + other non-interest income formula.
Impairments and provisions were also well calculable over the past decade by using the average impairments in the various portfolio items. Corporates and households each made up nearly half of the changes in impairments and provisions, the share of other items was negligible.

In liabilities, a major part of the decrease was due to the shrinkage in foreign funds. The share of foreign funds in banks' total liabilities dropped from 36% in March 2009 to 23% in March 2012. Total liabilities fell by HUF 3,461 billion over three years, including foreign funds by 3,023.

The developments of the past ten years are best reflected in the HUF 3,030 billion decline in domestic loans, consistent with the HUF 3,023 billion decline in foreign funds. All this is also consistent with the decline in ROE from +10% in 2009 to 0% in 2010 and -10% in 2011. This decline was largely due to the burdens imposed on banks by the bank tax and the Early Repayment Scheme. A HUF 400 billion extra burden on the HUF 2,330 billion equity of banks does not encourage funds inflow.

2. Operating environment

2.1. Financial transaction levy

A major government measure affecting banks in the second quarter of 2012 was the drafting of legislation on a financial transaction levy, to be imposed from 2013.

The government announced its plan to impose this new tax in early April, setting the rate of the proposed levy at 0.1%. It also became obvious that, as opposed to the EU concept, where the tax is mainly aimed at investment products, the proposed financial transaction levy will be imposed on payments, as a consumption tax. Given that the available statistics on payments were not suitable for calculating a combined tax, and in view of the constant changes in the extent of the proposed restrictions under Hungary's Convergence Program, the government's revenue expectations from this new tax kept changing, rising from the initially announced HUF 50-100 billion to 130-228 billion in the Széll Kálmán Plan 2.0 and Hungary's Convergence Program and to 380 billion in subsequent announcements. Finally, the final estimate was set at HUF 240 billion, of which 140 billion is expected to be collected from the banking sector.

The negotiations with the financial government on the proposed tax started by a meeting on May 8 between the responsible State Secretary of the Ministry for National Economy and the Association's Board. The meeting was also attended by representatives from PSZÁF and the MNB. At the meeting the Ministry presented the government proposal for the new tax.

The Association appointed a four-member negotiating team, with the mandate to achieve a refinement of the proposed regulation in a way acceptable for the industry and to develop a workable expert estimate for the expected tax liabilities, including the expected behaviour of the various groups of customers affected. The negotiations were supported by regular expert consultations between banks and the Economy Ministry, with the involvement of PSZÁF and the MNB.

The head of the Association's negotiating team, Dániel Gyuris, briefed the Board on the progress of the negotiations on a regular basis at extended Board Meetings, attended by CEOs of the banks affected the most.

As a result of the negotiations, a tax cap of HUF 6,000 was achieved and the scope of the tax was amended to exclude payment transactions related to lending and investment services, interbank transactions, and partially, cash-pools.

The Act on Financial Transaction Levy was passed by Parliament on July 9. Since the text of the legislation gives rise to a number of uncertainties in implementation, the review of the relevant issues with specialists from member banks and the drafting of a request for ruling from the Ministry for National Economy is underway.

2.2. Retail lending

2.2.1. Consultations with the Association of Hungarian Insurance Companies (MABISZ) on property insurance related to retail mortgage loan collaterals

Negotiations continued with MABISZ to improve the administration of property insurance for property provided as collateral for home loans. Specifically, the improvement and standardisation of the two main forms used in the contracting stage, the Assignment Statement and the Certificate of Collateral was discussed. Progress was made on a number of issues:

- The documents will address the issue of multiple creditors, providing all creditors with transparent information as to all the other creditors and the respective loan amounts covered by the insurance.
- The damage limit above which the insurance company should ask for the creditor(s) consent before paying any indemnification will be set at HUF 300,000.
- Due to their complexity, condominium insurance contracts will be excluded for the time being.
- Agreement was reached on the exchange rates to be applied for foreign currency loans.

Notifications to banks on delinquencies on insurance premium payments and on contract cancellations for default on premium payments will be managed through a joint insurance/banking interface.

2.2.2. Litigations related to foreign currency loans

We organised a presentation and consultation on lessons learnt from the litigation conducted by the Szeged Court for unfair general terms and conditions in foreign currency-denominated loan contracts. The consultation was attended by Gábor Gadó, the lawyer representing the bank in the case. We provided the Association's legal working group with regular information on subsequent Court Decisions adopted in similar cases, including the Supreme Court's Decision No. Gfv. IX. 30.275/2011 of March 20. This Decision is of particular importance: it provides that it is not unfair to set a handling fee in a loan contract, the unilateral amendment of the contact in itself is not illegal, banks cannot be expected to estimate future exchange rate changes and it is not against any law or good morale for the debt currency to be different from the repayment currency (application of buy and sell rates).

2.3. Corporate lending

2.3.1. SME lending

The Association got involved in activities of the European Banking Federation's SME Working Group in the spring of 2012. The EBF SME Working Group has the objective of promoting the efficient use of EU (EIB, EIF) funds and guarantee schemes, drawing attention to regional and economic differences in commenting on drafts and proposed revisions to the various SME programs, sharing experience in SME financing, presenting successful models, and liaising with EU officials responsible for SME financing. We had the opportunity to share the Hungarian position with the European Investment Fund (EIF) on the CIP, and its successor from 2014, the COSME guarantee scheme, highlighting the importance of changes (such as the inclusion of capital replenishment and short-term financing in the scheme) to make the scheme of interest for Hungarian banks and SMEs. The EBF regularly assesses the EIB's SME products. Our involvement in the working group allows us to comment on these products, by taking into account the Hungarian specifics.

We organised a consultation with leaders of the Hungarian Development Bank (MFB) on the MFB's new Enterprise Financing Program. We requested rulings from the MNB on some questions that could not be answered during the consultation.

We had written several letters to the Hungarian Enterprise Financing Company and the National Development Agency, requesting them to consult with banks before changing any conditions of the Jeremie Programmes. This is important with a view to ensuring that the funds made available to SMEs are used as efficiently as possible.

We attended the second quarter meeting of the Enterprise Promotion Council. At the meeting, application schemes for SMEs under the New Széchenyi Plan and proposed amendments to the SMEs Act were reviewed.

2.3.2. Agricultural lending

At the request of the Rural Development Ministry's Agricultural Economics Department we provided comments and proposals on the Ministry's initial concept for the drafting of terms and conditions for preferential loan facilities for arable land purchase. Then, we reviewed and commented on the Ministry's subsequent draft proposal for terms and conditions for preferential arable land purchase under the New Hungary Agricultural Development Loan Programme.

We organised a presentation session with Dr Zsolt Feldman (Deputy State Secretary, Ministry for Rural Development) and Anikó Horváth (Head of Section, Ministry for Rural Development) on land-based aid and other support schemes available in 2012.

We drew the Ministry's attention on two occasions during the second quarter to the approaching expiry of the land lease agreements concluded with the National Land Fund Management Agency and its legal predecessor and the need to address the situation. We made specific proposals to solve the issue. A response to our proposals is now being drafted at the Ministry.

We wrote a letter to the Ministries for National Economy and Rural Development, requesting them, to accelerate the proposed, and in our opinion, necessary, amendments to the Act on Public Warehouses. In response, the Ministry for Rural Development sent us the draft proposals for the revision of the Act. We maintain the proposals we made in consultation with professional organisations two years ago.

2.3.3. Late payments to subcontractors

Upon a request from the Ministry for National Economy, we reviewed and provided comments on proposed measures to reduce late payments to subcontactors, the draft proposal for an organisation to intermediate in disputes related to the execution of construction works and proposed amendments to certain laws to prevent late or non-payments to subcontractors. We drew the Ministry's attention to the key issues that should be addressed to achieve the objective, which is important also for the banking sector. A meeting attended by the Ministry for National Economy, the Association and representative from banks was also held on the issue.

2.4. Central Credit Bureau

The issues related to the contents and interpretation of the data registered in the Central Credit Bureau were clarified in the first quarter of this year. The key task for the project in the second quarter was to ensure the proper upload of the information into the database by the set deadline.

The upload of positive data (performing retail loans) into the system was carried out by the deadline provided by law:

- 8.2 million data were uploaded, including the re-entry of 1.7 million previously negative data. The 8.2 million data belong to 4.2 million natural persons.
- With an additional 1.3 million corporate loan data, the Central Credit Bureau currently contains a total of 9.5 credit data.

The project's working groups held meetings as necessary during the upload. The key issues addressed included

- the interpretation of data received upon inquiries from the system,
- the fixing of minor technical and information technology problems encountered during upload.

With the completion of the upload, the project has been concluded. In the Board's opinion, by ensuring the necessary organisational framework, the project has made a valuable contribution to the proper and timely implementation of the legislation. The availability of comprehensive credit information will contribute to increasing lending security.

2.5. Amendments to the MNB decree on payments in the context of IG2

Before the July 2 go-live of the intraday settlement system (Intergiro - IG2), the MNB sent us for review a draft amendment to its decree on payments.
Since the proposal affected the system of intraday settlements to be launched within weeks, at the request of members, the Association expressed its disapproval of the timing of the proposed amendments. In our relevant letter, we pointed out that due to the short time provided for implementation, it was physically impossible to carry out the proposed changes and to pre-announce them in time as required by relevant consumer protection regulations. We also said that due to the preparations for the introduction of the intraday settlements system, banks did not have the resources to review those changes not related to IG2.
With the MNB insisting on the implementation of the proposed amendments to the decree, the Association organised several oral and written consultations for specialists from banks and from the MNB. These consultations were primarily focused on

- making available the credits received through IG2 to customers in a timely fashion,
- the treatment of payment instructions (in particular those related to administrative collection orders) with respect to the 4-hour rule, and
- the upgrading of the direct debits system.

During the consultations, we managed to obtain that only those amendments

- absolutely necessary and not jeopardising the go-live of IG2 and
- helping the execution of payment instructions for the benefit of customers

are introduced with immediate payment effect and the implementation date for changes not related to IG2 is extended by six months.
The intraday settlements system was successfully launch on July 2, 2012.
The IG2 project was managed by the MNB in collaboration with GIRO, banks, the Hungarian SEPA Association and the Hungarian Banking Association. The Association's staff actively supported implementation in the project's steering committee and working groups.

3. Regulations affecting banks

3.1. Tasks related to the New Civil Code

The Association provided comments on the proposed new Civil Code to the Ministry of Justice. Consultations on the draft laws continue. We attended a several-day consultation headed by the State Secretary Róbert Répássy and professor Vékás. On April 9, the chapter on legal entities was reviewed, a number of our proposals related to the provisions on business organisations were accepted. The consultation on April 24 addressed the economic chapters of the Civil Code: the lien laws, general contract law and the laws related to certain contracts. The meeting was attended by representatives from the National Judicial Office, the Hungarian Chamber of Notaries, the Hungarian Bar Association and the affected ministries.
The draft of the new Civil Code was presented to Parliament under No. T/7971 on July 11, 2012, the text has been published. We will follow the legislative process closely to prevent any amendments detrimental to business and lending.

3.2. Bankruptcy laws

3.2.1. Implementation decrees related to the Bankruptcy Act

The review of the proposal for and draft of Government Decree 114/2006 (V 12) on **Liquidators Register** continued in May. In our comments we noted that most of our previous comments had not been taken into account. We highlighted the most important points made earlier, including the absence of an organisation representing creditors on the appraisal committee, the unsolved issue of the professional supervision of liquidators and the appraisal criteria containing conditions favouring major and financially strong liquidators and those already present in the market. (e.g.,: points d) and e) of subsection (5) and subsections (8), (9) (10) and (13) of Section 3). These conditions do not help transparency or the renewal of the profession.

3.2.2. Electronic sale of assets under liquidation

We reviewed the proposed legislation in several rounds. We proposed that the management and supervision of the electronic sales system is put under government control. Also, we provided some methodology proposals. The Ministry of Justice recently sent us a revised proposal. Pursuant to this, the electronic sales system will be developed and operated by the Central Office for Administrative and Electronic Public Services (KEKKH). This means that in this respect, our proposal was accepted.

3.2.3. Action points, related to insolvency, of the medium-term government programme for reducing the administrative burdens of businesses

We provided comments regarding the points related to the review of practical means available for the enforcement of liability rules in the case of imminent insolvency, potential regulatory measures to simplify the procedures for composition and the review of the current practice for compositions, urging for improvement of the regulatory framework.

3.3. Prudential regulation

Main developments in the area of prudential regulation in the second quarter included the following:

A. PSZÁF issued its Recommendation No. 6/2012. (IV 17) on the treatment of underlying exposures under the large exposure rules (the Association reviewed and commented on the draft Recommendation in the first quarter).
B. PSZÁF published for consultation a proposed methodology guide for recovery plans.
C. An amendment to Government Decree 366/2011 (XII 30) on liquidity coverage requirements for credit institutions and on the maturity mismatch of foreign currency positions of credit institutions was enacted. Pursuant to this, the minimum balance sheet coverage ratio for mortgage banks was reduced from 0.1 to 0.05.
D. The Ministry for National Economy, MNB and PSZÁF published for consultation a joint concept for the treatment of general provisions in accordance with Basel III. The concept will be adjusted based on the consultation and an additional review is expected in November.

3.4. Relations with PSZÁF

3.4.1. PSZÁF draft recommendation on consumer protection principles for debt collection

Recognising the shortcomings of the regulation of debt collection activities, PSZÁF has developed a regulatory concept, proposing comprehensive legislation to address the issue. Also, until such legislation is adopted, PSZÁF proposes to issue a recommendation to institutions engaged in debt collection, to enforce consumer interests. We provided detailed comments on the relevant consultation document. We proposed that the apart from consumer protection aspects, the recommendation should address the aspects of customer conduct, with separate rules for cooperative and uncooperative customers. We also proposed that the recommendation should be extended to debt settlement procedures. We organised a consultation meeting between PSZÁF and specialists from banks on the proposed recommendation.

3.4.2. PSZÁF draft recommendation on lending against pledge

We reviewed the proposed PSZÁF recommendation on lending against pledge by dependent intermediaries. In our comments we drew attention that the regulation of these activities was inadequate. Pawnbroking cannot be considered as classic lending. It is not identical to a loan agreement as defined in the Civil Code, nor can it be unequivocally categorised as "provision of credit" under the Credit Institutions Act. The lender's risk in this case is different: there is **no real credit risk**, since the lender anticipates that the borrower will not pay. (Accordingly, there is no credit rating, pawnshops do not look at the financial position or income of the customer, usually they do not even know who the customer is). In this case, **the risk is more related to the appraisal of the pledge and the chances for its resale**). A specific characteristic of the arrangement is the application of the rules for independent lien in refinancing and in the settlement of title to unredeemed pledges. Due to the specifics of these activities, the regulations on lending are not applicable to them (or so only by a far-fetched and bureaucratic logic). In view of the above, we also provided detailed comments on the relevant licensing requirements.

3.4.3. New supervisory reporting requirements on bank account products

After introducing a website service to help retail customers in choosing between the various loan and savings products offered by banks, PSZÁF drafted and sent us for review its proposed reporting requirements for a similar service for bank account products. Summarising members' opinions, we indicated that the requirements were unclear in a number of points. Accordingly, we proposed certain clarifications and some additions to ensure clear and consistent application.

3.5. Taxation

3.5.1. Taxation issues, activities of the Association's Taxation Working Group

In May, the Association, with the involvement of its Taxation Working Group, provided comments to the Ministry for National Economy on the draft legislation on amendments to the Act on bank tax and other taxation regulations, submitted to Parliament. The proposals were related to the rules for the contribution payable by banks under the arrangement on the settlement of 50% of the interest above the exchange rate cap related to buffer account loans and the bank tax refund for debt cancellations related to 90+ days delinquent foreign currency loans. Also, we provided proposals to clarify the rules related to the tax refund due in 2012 under the Growth Pact set out in the agreement concluded with the government in December 2011.
At its meeting, the Taxation Working Group agreed to start preparations for the government proposals for 2012 tax laws, expected to be published in the autumn. For example, it would be important to complement the Personal Income Tax Act's provisions related to 3-5 year savings contracts with regard to partial redemptions at the end of the third year: the due date is approaching and these details are not addressed in the relevant, preferentially taxed, long-term savings contracts. Also, certain questions have arisen at banks regarding the handling of preliminary pension savings accounts (decease, switching of bank accounts) that should be settled through amendments to the legislation. Banks are also working on some proposals related to other tax types.

In relation to international treaties on the avoidance of double taxation, we submitted to the Ministry for National Economy a proposal for aspects to be taken into account in these treaties. We proposed that local trade tax, an important items for businesses, should be included in these treaties. In relation to the taxation of interest income, we proposed, for practical reasons, that interest income should not be subject to withholding tax in the source country. This is consistent with the relevant OECD recommendation and justified by practical experience. Namely, neither exemption, nor deduction from the tax liability are suitable for eliminating double taxation.

Specialists from member banks are actively working on the issue of VAT on bank card services. We requested a ruling from the Ministry for National Economy regarding the interpretation of the VAT Act.

3.5.2. FATCA compliance

Compliance with the U.S. Foreign Account Tax Compliance Act (which has been amended several times to take account of comments from market players) is a challenge for Hungarian banks as well, as a number of the FATCA's provisions conflict with Hungarian laws. It is important for Hungarian banks to be able to comply with the FATCA, with the minimum possible burdens. To achieve this, we proposed to the Ministry for National Economy that an agreement be concluded at the government level with the U.S. authorities and the responsible Hungarian government agencies initiate a bilateral agreement with the U.S. Treasury and the IRS agreement with the U.S. Treasury and the IRS for Hungary to become an FATCA Partner, as five EU member states (France, Germany, Italy, Spain and the U.K.) states have done.

Compliance by financial institutions with the FATCA is of overall importance for Hungary: in case of non-compliance, customers subject to U.S. tax laws will only receive 70% of the amounts paid from U.S. sources. Under the FATCA, in case of non-compliance, 30% will be withheld as a withholding tax even if the beneficiary is not subject to U.S. tax laws. Failure to comply with the FATCA may lead to a loss of customers and liabilities. An inter-government agreement would be mutually beneficial for the contracting parties: reporting (and tax withholding) would be done at the governments' level rather than by the individual financial institutions. Thus, Hungarian authorities would be provided with information on U.S.-held accounts of Hungarian taxpayers. Solving the legal obstacles in Hungary is difficult, particularly in view of the fact that the EU data protection laws are not in par with the U.S. requirements.
After the last year's conference on the FATCA, we organised an additional two technical days for members, providing a summary of the challenges and orientation for the work to be done by the Association's working groups.

3.6. Amendments to the Ministry Decree on Reporting requirements for publicly offered securities (Decree No. 24/2008. (VIII 15)

We provided comments on the relevant draft decree of the Ministry for National Economy. We made proposals regarding disclosure in the press and reiterated our proposal to provide the obligations of issuers of debt securities in a clear-cut manner, by adding a provision to require issuers to file extraordinary reports on interest payments made during the term of the security.

3.7. Proposed amendments to the Expropriations Act (Act CXXIII of 2007) and certain related laws

During this review we provided comments regarding the settlement of the mortgage on the expropriated property and the procedure for remedies. Also, we attended the administrative review meeting at the Ministry.

3.8. Data protection

The Privacy Act (Act CXII of 2011) contains a new provision requiring banks and insurance companies to register with the National Authority for Data Protection and Freedom of Information. Jointly with the Association of Hungarian Insurance Companies, we requested a ruling from the National Authority on the interpretation of the law and on the practical procedure for registration. We received positive answers to our questions and a small specialist team of the Association and MABISZ was received for consultation by the deputy head of the Authority. This was followed by an exchange of letters on the interpretation of the legislation. The relevant correspondence was distributed to all members. Partly as a result of these actions, members were able to meet their statutory obligations in a timely fashion.

A **Data Protection Sub-Working Group** was set up under the Legal Working Group in July. The Data Protection Sub-Working Group is charged with monitoring the developments in Hungarian and international regulation, developing common interpretations and best practices mindful of the relevant competition law provisions, and, if necessary, requesting rulings and drafting amendment proposals to the legislation. Directive 95/46/EC of the European Parliament and of the Council on the protection of individuals with regard to the processing of personal data and on the free movement of such data as well as the proposed EU regulation now under drafting, encourage trade associations to draw up codes of conduct to facilitate the application of the Directive, taking account of the specific characteristics of the processing carried out in certain sectors, and respecting the relevant national provisions. The Sub-Working Group is a forum, based on voluntary participation, for banks' data protection officers and for banks' legal counsels, compliance and IT officers interested in data protection issues.

3.9. Central bank reporting

In May, the MNB solicited the banking sector's preliminary views on its proposed reporting requirements for 2013 and long-term strategic reporting requirements. (Following this preliminary survey, the MNB published for review the relevant draft legislation, as well). As was the case in previous years, the MNB launched a cost estimate exercise and held a consultation with banks. The consultation was also attended by the Association's staff members.
In relation to the proposed changes, the Association requested that the purpose and use of the data, and the publication, where aggregate data for the sector will be available, be indicated in all reporting guides and templates. This would allow the elimination of obsolete reports and the reporting entities would be able to see the purpose and significance of the reports.
We did not support the transaction-level reporting specified in the long-term reporting strategy. Transaction level-reporting would not help solve the problem of the ever-increasing reporting burdens. The objective (also supported by banks) of a controlled and high-quality reporting cannot be achieved with a transaction-level reporting. The capacity requirements for sending and storing the data may pose problems, especially for banks with nationwide networks.

4. European Banking Federation, Executive Committee Meetings

The EBF Executive Committee (ExCo) held two meeting in the second quarter. Key issued addressed included the review of proposed EU regulations and lobbying.

Key priorities for the ExCo in the second quarter included:

a) CRD4/CRR („ongoing” – trilogue commenced, but suspended until September)
b) The proposed EU Directive for a framework for the recovery and resolution of credit institutions and investment firms (the European Commission published the draft directive in June. There is no set legislative schedule for it, the legislative process is expected to commence in September).
c) European Banking Union (the European Commission published a proposal for a European Banking Union concurrently with the draft directive on a recovery and resolution framework. ExCo comments are being drafted).
d) MiFID („ongoing” – under discussion by EP committees, a compromise text is to be submitted to the European Council by October 2012).
e) Mortgage lending („ongoing” – EP committee and Council reviews concluded, trilogue to commence in September).
f) Financial Transaction Tax („ongoing” – discussion between European Council and member states in process, including alternative taxation options).
g) FATCA („ongoing” – seeking a pan-European solution)

Additional issues addressed by the ExCo in the second quarter included:

h) Ring-fencing/structural market reforms – (EBF position sent to the Liikanen High Level Expert Group in June. High Level Expert Group to present report by September 2012).
i) Shadow banking (consultation on the Commission's Green Paper in process. The focus is now on the consultation conducted through the IBFed with the FSB, the Basel Committtee and IOSCO).
j) Retail bank accounts (a common regulatory package addressing the issues of transparency, comparability, bank account switching and basic bank accounts. EBF position submitted in June).
k) Central Security Depositories (draft legislation submitted, discussion suspended by the Danish presidency).
l) SEPA and EPC governance (in June 2012, the SEPA Council requested the European legislators to give it the mandate to manage implementation of the SEPA Payment Schemes. Upon the European Commission's competition concerns and investigation, the EPC decided to stop work on an e-payment framework).
m) Deposit Guarantee Schemes (being addressed in conjunction with the proposed recovery and resolution framework. A compromise proposal for the European Parliament is being drafted by the European Council).
n) After several months of drafting, the EBF discussed and adopted the EBF communications strategy. Also, it agreed to publish an „EBF Statements Book" on a regular basis. This is aimed to provide a summary of the key issues affecting the European Banking Community and the EBF's positions and support the communications of national banking associations on these issues.

5. Association life, events

5.1. General Meeting 2012

The Association held its General Meeting on April 20. The General Meeting adopted the reports on the Association's activities and financial management in 2011, the report on the main challenges in 2012 and the Association's budget for 2012. The General Meeting elected two new board members to replace two resigning members. It also elected a new Chair of the Ethics Committee.
The Association's new Golden Beehive Award was presented to colleagues who made outstanding contributions to the Association's professional and advocacy work.

5.2. Bylaws

At its June meeting, the Board approved the Association's Bylaws. The Bylaws detail the provisions of the Association's Rules with respect to internal regulations, management, communications, information and data protection, document management and the rules for the operation of the Association's working organisation, working committees and working groups.
Following a competition law review and adjustments, the Bylaws took effect in July.

5.3. New working group heads

The Card and Compliance Working Groups adopted their new operational rules and elected their new leaders.

5.4. Communications

The Association continued to conduct intense communications in the second quarter. Media and public attention was primarily focused on the following issues:

- Changes in the rules for the Exchange Rate Cap Scheme (timing and deadline).
- Addressing the situation of foreign currency debtors with more than 90 days in arrears. Launch of the National Asset Management Company.

- The new Financial Transaction Levy and its potential impacts on the banking system and on corporate and retail customers.
- Changes in the legislation on the Home Protection Programme and access to subsidised home loans.
- The banking sector's profitability, funding, lending activity, changes in the conditions for foreign fundraising.

5.5. Human and Physical Security Working Group - Consultation with the Interior Ministry

The Association wrote a letter to the Minister of Interior to correct the provisions on remote alarm services in the case of false alarm under the Act on personal and property security (Act CXXXIII of 2005). In June, the Ministry initiated a consultation on the issue. As a result of the consultation, the Ministry submitted an amendment proposal to the Act.

5.6. Technical Day at the Hungarian Judicial Academy

In response to our earlier initiative, the Hungarian Judicial Academy requested us to hold a technical day on banking. The event was opened by our Board member, László Balázs. The presentations reviewed technical issues related to the laws applied in litigations (foreign currency lending, unilateral contract amendments, unfair terms and conditions). The feedback on the technical day was highly positive and we look forward to having further opportunities to contribute to judge's financial knowledge.

5.7. Conference at the Competition Culture Centre

We received an invitation from the Hungarian Competition Authority's Competition Culture Centre for a conference on the relationship between association activities and competition law. This issue is of interest also in light of the Competition Authority's investigation of the BankAdat database, with a view to answering the question of where the borderline between cooperation between advocacy organisation and anti-competitive conduct lies. We have established good relations with the Competition Culture Centre over the years.

5.8. Liaison with fellow associations

We took up contact with the renewed legal section of the Association of Hungarian Insurance Companies and agreed to hold regular consultations on issues affecting both profession.

In May, we participated as a moderator in the roundtable on better customer service at the private banking conference organised by the IIR.

We attended and provided organisational and other support to the conference on "Unilateral Contract Amendments in the Hungarian Economy", organised by the Pázmány Péter Catholic University's Commercial Law Department. The conference was of special importance in that it looked into the regulatory and practical issues related to unilateral contract amendments not only in the banking sector but in other sectors, in particular, the communications and the energy sectors, as well.

ANNEX

A) INTERNATIONAL DEVELOPMENTS: REGULATION, SUPERVISION - EUROPEAN BANKING FEDERATION

I. Global regulation

I.1 Consistency in the implementation of Basel III

I.1.1. Basel III implementation review programme

The Basel Committee on Banking Supervision (BCBS) considers that the full, timely and consistent implementation of Basel III is fundamental to raising the resilience of the global banking system, maintaining market confidence in regulatory ratios, and providing for a level playing field. To help implementation, the Basel Committee has agreed to establish a program to assess implementation by its members of Basel III. The assessment programme includes three levels of review:

- Level 1: ensuring the timely adoption of Basel III;
- Level 2: ensuring regulatory consistency with Basel III; and
- Level 3: ensuring consistency of risk-weighted asset outcomes.

The document, published by the Basel Committee in April, describes the Level 2 review process. This aims to identify national regulations that are not consistent with the rules agreed by the Committee and to assess their impact on financial stability and on the international level playing field. The review includes the scope of application, transitional arrangements, the definition of capital, the supervisory review process, minimum capital requirements disclosure requirements, liquidity standards and leverage ratio.

The conclusions on the assessment of each jurisdiction will be published.

I.1.2 BCBS progress report on Basel III implementation

In accordance with the above and its announcement in October 2011, the Basel Committee assesses Basel III implementation in its member countries on a regular basis. The progress report, published in April, reviews the timely adoption of Basel III in the various jurisdictions. The first reviews of compliance of national regulations with the international minimum requirements in the USA, EU and Japan are expected to be published by the end of September. A preliminary assessment of risk-weighted assets consistency is also expected to be communicated in the course of 2012.

The report establishes that the USA continues to be delayed in implementing Basel 2.5 (strengthening market risk capital and securitisation capital requirements): some rules are under development as part of Basel III implementation, some others need to be coordinated with the Dodd-Frank legislation. Pursuant to the report, the issue of a draft regulation for consultation in the U.S. was planned for the 2nd quarter. Japan has adopted the necessary legislation, legal implementation in the EU was expected in June.

(Since the publication of the report, the U.S. regulatory authorities have published the rules for Basel 2.5 implementation [see I.7 below]. Legal implementation in Europe is delayed).

I.2 BCBS consultative document on review of the trading book

At the beginning of May, the Basel Committee launched a consultation on the fundamental review of the trading book capital requirements[1]. Comments are invited by September 7, 2012.

The 2009 revisions to the market risk framework (Basel 2.5) significantly raised the trading book capital requirements, in particular for securitisation and structured credit products, mostly relying on the previous definitions and regulatory framework. However, the Committee recognised at the time that the Basel 2.5 revisions did not fully address the shortcomings of the framework. Therefore, it initiated a fundamental review of the trading book regime to address shortcomings in the overall design of the regime as well as weaknesses in risk measurement under both the internal models-based and standardised approaches.

The consultation paper sets a new market risk framework, including specific measures to strengthen the capital requirements for trading book exposures. The proposals reflect the Committee's increased focus on achieving a regulatory framework that can be implemented consistently by supervisors and which achieves comparable levels of capital across jurisdictions.

The key elements of the proposal are as follows:

- Better defining the boundary between the trading book and the banking book by using more objective requirements, thereby reducing the possibility of regulatory arbitrage. The Committee offers two alternative boundary definitions: a trading-based boundary and a valuation based boundary.
- Moving from value-at-risk (VaR) to expected shortfall (ES). ES is a risk metrics that can better capture the tail of the loss distribution ("tail risk"). In other words, expected shortfall measures the likelihood of losses above a certain confidence level.
- Moving to a capital framework that is calibrated to a period of significant financial stress in both the internal models-based and standardised approaches, consistent with the direction taken in Basel 2.5.
- A comprehensive incorporation of the risk of market illiquidity, consistent with Basel 2.5.
- Measures to reduce the weaknesses of the internal models-based approaches, including strengthening the model approval process and the treatment of hedging and diversification.
- A revised and more risk-sensitive standardised approach, as a credible alternative to the internal models-based approaches.

The Committee also proposes to strengthen the relationship between standardised and internal models-based approaches by establishing a closer link between their calibration and requiring mandatory calculation of the standardised approach by all banks. The Committee is also considering the merits of introducing the standardised approach as a floor or surcharge to the models-based approach. The treatment of hedging and diversification will be aligned under the two approaches.

I.3 BCBS consultative document on a framework for dealing with domestic systemically important banks (D-SIBs)

In November 2011, the Basel Committee issued a set of rules for global systemically important banks (G-SIBs). Subsequently, the G20 leaders requested the Basel Committee and the Financial Stability Board to work on the modalities to extend the G-SIFI framework to domestic systemically important banks (D-SIBs). The BCBS's proposal allows an appropriate degree of national discretion in the assessment and application of policy tools in order to accommodate the structural characteristics of individual jurisdictions.

The Committee has developed a set of principles to address D-SIBs. The 12 principles can be broadly categorised into two groups: the first group (Principles 1 to 7) focuses mainly on the assessment methodology for D-SIBs, while the second group (Principles 8 to 12) focuses on Higher Loss Absorbency for D-SIBs.

[1] The term "trading book capital requirements" is used as a shorthand to refer to capital charges against market risk in the trading book as well as FX and commodity risk in the banking book.

The principles for the assessment methodology are as follows:

1. National authorities should establish a methodology for assessing the degree to which banks are systemically important in a domestic context.
2. The assessment methodology for a D-SIB should reflect the potential impact of, or externality imposed by, a bank's failure.
3. The reference system for assessing the impact of failure of a D-SIB should be the domestic economy.
4. Home authorities should assess banks for their degree of systemic importance at the consolidated group level, while host authorities should assess subsidiaries in their jurisdictions, consolidated to include any of their own downstream subsidiaries.
5. The impact of a D-SIB's failure on the domestic economy should, in principle, be assessed having regard to bank-specific factors, including:
   - size,
   - interconnectedness,
   - substitutability/financial institution infrastructure (including considerations related to the concentrated nature of the banking sector), and
   - complexity (including the additional complexities from cross-border activity)
6. National authorities should undertake regular assessments of the systemic importance of the banks in their jurisdictions to ensure that their assessment reflects the current state of the relevant financial systems and that the interval between D-SIB assessments is not significantly longer than the G-SIB assessment frequency.
7. National authorities should publicly disclose information that provides an outline of the methodology employed to assess the systemic importance of banks in their domestic economy.

The principles for Higher Loss Absorbency (HLA) are as follows:

8. National authorities should document the methodologies and considerations used to calibrate the level of HLA that the framework would require for D-SIBs in their jurisdiction (quantitative methodologies, country-specific factors).
9. The HLA requirement imposed on a bank should be commensurate with the degree of systemic importance, as identified under Principle 5. In the case where there are multiple D-SIB buckets in a jurisdiction, this could imply differentiated levels of HLA between D-SIB buckets.
10. National authorities should ensure that the application of the G-SIB and D-SIB frameworks is compatible within their jurisdictions. The home authority should test that the parent bank is adequately capitalised on a standalone basis, including cases in which a D-SIB HLA requirement is applied at the subsidiary level. Home authorities should impose the higher of either the D-SIB or G-SIB HLA requirements in the case where the banking group has been identified as a D-SIB in the home jurisdiction as well as a G-SIB.
11. In cases where the subsidiary of a bank is considered by a host authority to be a D-SIB, home and host authorities should make arrangements to coordinate and cooperate on the appropriate HLA requirement, within the constraints imposed by relevant laws in the host jurisdiction.
12. The HLA requirement should be met fully by Common Equity Tier 1 (CET1). In addition, national authorities should put in place any additional requirements and other policy measures they consider to be appropriate to address the risks posed by a D-SIB.

The consultation ran until August 31. The new framework is to be implemented in line with the phase-in arrangements for the G-SIB framework, i.e. from January 2016. The Committee will monitor the implementation of the principles under the Basel III implementation review program. (See point I.1.1 above).

I.4 BSBC consultation on monitoring intraday liquidity management

The Basel Committee has published for consultation a proposal for monitoring indicators for intraday liquidity management. The consultation runs until September 14. Intraday liquidity can be defined as funds that are accessible during the business day, usually to enable financial institutions to make payments in real time. The indicators proposed by the Committee would allow banking supervisors to monitor a bank's intraday liquidity risk management and its ability to promptly meet payment and settlement obligations, both in normal times and in stressed scenarios. Over time, the indicators will also help supervisors gain a better understanding of banks' payment and settlement behaviour and their management of intraday liquidity risk. The proposed monitoring framework includes:

- the definition and constituent elements of intraday liquidity,
- the detailed design of the monitoring indicators for a bank's intraday liquidity risk,
- stress scenarios,
- key application issues, and
- the reporting regime.

The proposed monitoring indicators are as follows:

(i) Daily maximum liquidity requirement
(ii) Available intraday liquidity
(iii) Total payments
(iv) Time-specific and other critical obligations
(v) Value of customer payments made on behalf of financial institution customers
(vi) Intraday credit lines extended to financial institution customers
(vii) Timing of intraday payments
(viii) Intraday throughput

The proposed indicators complement the guidance on intraday liquidity risk management set out in the Basel Committee's 2008 Principles for Sound Liquidity Risk Management and Supervision.

I.5 Financial Stability Board activities regarding disclosure and reporting requirements

1. The FSB held a roundtable, where it was established that supervisors were imposing **increasingly stringent requirements for risk disclosures**. Supervisors would like to increase the reporting frequency and enhance the comparability of disclosures, strengthen the analytical and forward-looking nature of the disclosures and reduce the reporting deadlines. At the same time, the standards should be developed by taking into account market (private sector) needs. The FSB requested market players and investors to jointly develop a proposal for risk disclosure principles and practice.

2. In May, the FSB announced the formation of an **Enhanced Disclosure Task Force (EDTF)**. The Task Force has three high-ranking co-chairs and 25 senior officials and experts representing financial institutions, investors, analysts, credit rating agencies and external auditors. The primary objectives of the EDTF are (i) to develop principles for enhanced disclosures, based on current market conditions and risks, including ways to enhance the comparability of disclosures, and (ii) to identify leading practice risk disclosures presented in annual reports for end-year 2011 based on broad risk areas such as those identified in the summary of the first FSB roundtable on risk disclosures, held in December 2011. The EDTF will have dialogue with key standard-setting bodies. The recommendations of the Task Force are expected to be published during October 2012.

3. At the beginning of October 2011, the FSB published a **consultation paper on a common template for systemically important banks**. On May 2, the FSB organised a workshop on this issue. The workshop was

also attended by the IBFed[2]. At the workshop, representatives from the FSB explained the objectives of the various reports. Industry representatives emphasised the need for further dialogue and the importance of aligning regional and national reports. They also suggested the setting up of an industry advisory body.

I.6 FSB interim report on securities lending and repos

In relation to the regulation of shadow banking, the FSB focuses on five key areas. One of these areas is securities lending and repo transactions. The FSB published an interim report on securities lending and repos in April. Comments were invited by May 25. The report reviews four segments of the securities lending and repo market, including their key drivers. It analyses the role of these transactions play in the shadow banking system, the current regulatory frameworks for securities lending and repos and the financial stability issues posed by these markets.

During the consultation the IBFed emphasised that securities lending and repo transactions were of fundamental importance for credit institutions and other market participants to ensure adequate liquidity. Consequently, any regulatory requirements regarding securities lending and repo transactions should be balanced and take into account the importance of these activities to avoid any unintended consequences. The IBFed would favour increased transparency for these types of transactions with particular emphasis on globally consistent disclosures.

I.7 Basel 2.5 implementation in the U.S.

The FED and the other U.S. regulatory agencies published the long-awaited rules for the implementation of Basel 2.5. Taking effect on January 1, 2013, the new rules implement the 2009 Basel decision on market risk capital, mindful of the provisions of the Dodd-Frank Act (such as the prohibition of the use of the standardised approach for loans and securitised exposures).

II. European Union

II.1 Commission technical consultation on the debt write-down tool - bail in

Ahead of the publication of its proposal for a Directive on bank resolution, the European Commission conducted a technical consultation on the debt write-down tool.

The purpose of debt write-down is to stabilise the financial institution without the need for public bail out. In a bail-in, the shareholders and creditors bear the losses, while the liabilities to depositors, employees, trade creditors and authorities remain. Bail-in complements conventional resolution tools (such as the sale of business, the bridge bank, asset separation, etc.)

The debt write down tool is a tool by which resolution authorities could be given a statutory power, exercisable when an institution meets the trigger conditions for entry into resolution, to write off all equity, and either write off subordinated liabilities or convert them into an equity claim. The debt write down tool can be used both in a going concern scenario and a liquidation (gone concern) scenario. A key principle is that no creditor should be worse off than if the bank went into insolvency. In the Commission's view, it is important that

- the bail-in respects as far as possible the ranking of creditors' claims under insolvency law;
- legal certainty is given to investors as to when and under which conditions their claims would be converted to equity or written down;

---

[2] 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)

- banks have sufficient "bail-in-able" liabilities; and
- the cost of funding for banks is minimized.

In the Commission's opinion, the bail-in tool would have been helpful in minimizing the impact of the current crisis on public finances. However, the short-term impact of the bail-in tool on banks' access to market funding, in particular in times of financial stress, has not yet been tested.

II.2 European Commission proposal for a Directive establishing a framework for the recovery and resolution of credit institutions and investment firms

After several communications, working papers and consultations, the European Commission published its proposal for a Directive establishing a framework for the recovery and resolution of credit institutions and investment firms on June 6, 2012. Consistent with the scope of application of the CRD, the proposed Directive would be applied to all credit institutions and investment firms, regardless of size and scope of activities.

The proposed framework aims to provide authorities with an effective common framework for crisis resolution without taxpayer money being used. The ultimate objective is to allow an insolvent credit institution to exit the market without jeopardising financial stability, while minimising the risk of contagion. As opposed to normal insolvency proceedings, a special bank resolution framework would allow authorities to use a set of tools and techniques that take into account the specifics of the bank, thus ensuring the protection of investors and the continuity of the business. Bank resolution is closely linked to non-harmonised areas of national law, such as insolvency and property law.
Key elements of the proposed resolution framework include Recovery and Resolution Plans (RRPs), early intervention arrangements, resolution authorities, resolution funds and the write down of debt (bail-in).

Recovery plans are aimed to prevent insolvency. They should be prepared at the consolidated and solo levels. Supervisors should comprehensively assess the recovery plans (which should include various scenarios), examining whether the plans are comprehensive and could feasibly restore an institution's viability, in a timely manner, even in periods of financial stress. Regarding group recovery plans, the proposal aims to allow the ***transfer of financial support between group members*** based on voluntary agreements (group members that pursue riskier activities maybe excluded). As a safeguard, the supervisor of the transferor will have the power to prohibit or restrict financial support if the transfer threatens the liquidity or solvency of the transferor.

In relation to recovery plans, the proposal extends supervisors' ***early intervention*** powers. Authorities would be provided with the tools for effective, early and rapid intervention aimed at ensuring the continuity of the credit institution's essential financial and economic functions. Under these powers, supervisors may intervene at an early stage in cases where the financial situation or solvency of an institution is deteriorating. The supervisor may

- require the institution to cease certain activities,
- require the institution to restructure its debts,
- appoint a special manager for a limited time.

Member states should set up or appoint a ***resolution authority***. This may be the central bank, the financial supervisory authority, the deposit guarantee scheme, the ministry of finance or a special authority set up for this purpose (optionally from several authorities). It is essential that the resolution function is separated from other functions of the designated authority.

Resolution plans should be prepared by the resolution authorities in cooperation with supervisors in normal times. The plans should include details on the application of resolution tools and ways to ensure the continuity of the critical functions.

Should the resolution measures and early intervention be unsuccessful, the resolution authority should ***assess whether the institution is resolvable***. If the institution is not resolvable, the resolution authority may require the institution to take measures to facilitate its resolution. Such measures may include changing the institution's legal or operational structures, amending service agreements to ensure the provision of critical functions, limiting exposures, limiting or ceasing certain activities, restricting or prohibiting the introduction of new lines of business or products and issuing additional convertible capital instruments. It is essential that the assessment of resolvability and the use of preventive powers by the relevant authorities are consistently applied across member states

The proposal establishes ***triggers*** for the application of resolution tools: given that resolution measures will entail losses for shareholders and creditors, they should only be implemented if the institution is failing or likely to fail and the resolution authority's discretion in applying resolution measures should be limited. Also, it should be justified that there is no other solution that would restore the institution within an appropriate timeframe and resolution action is necessary in the public interest.

When the trigger conditions for resolution are satisfied, resolution authorities will have the power to apply the following ***resolution tools***:

- sale of business
- bridge institution,
- asset separation,
- bail-in (debt write-down).

These measures should be applied in a manner consistent with the rules for state aid. Member states may take additional resolution measures provided they are compatible with the EU resolution framework.

The decisions of the resolution authority may be legally challenged, however, remedies would be limited to compensation for the loss suffered by the applicant as a result of the decision. If there is an insolvency proceeding filed against the institution, the resolution authority will have 14 days to decide on a resolution action.

An important new element in the proposal is the introduction of a ***bail-in tool***. (See the previous point of this report). The bail-in would be accompanied by the removal of management responsible for the problems of the institution. The bail-in tool will remove the implicit certainty of state guarantee even for the largest and systemically important banks. As a natural consequence, the bail-in tool may lead to an increase in the funding costs for banks. The European Commission estimates this cost increase to be around 15 basis points. (Harmonised application of the bail-in tool will be regulated by the European Commission by a delegated act).

The resolution authority may temporarily limit or suspend the ***safeguards for counterparties*** (e.g., the right to enforce claims, close-out netting). The suspension should be limited in time and imposed by taking into account the parties' interests on a pari passu basis.

Member states should set up resolution funds, to be financed from ex ante and ex post contributions. If indispensable, the funds may borrow from financial institutions or the central bank. The minimum target level of the funds should be reached in 10 years. The minimum target fund level is proposed to be set at 1% of covered deposits. National resolution funds may borrow from their counterparts in other member states on a voluntary and mutual basis.

During the resolution process, Deposit Guarantee Schemes (DGSs) should contribute to resolution by making available the funds for covered assets. (Deposit Guarantee Schemes will rank pari passu with unsecured non-preferred claims). Deposit Guarantee Schemes may also be used in general in the resolution process. The decision whether the resolution fund should be separate from the Deposit Guarantee Scheme would be a national discretion. However, the Commission considers that there are significant synergies between DGS funds and resolution measures. Therefore, the proposal would allow member states to use the

DGS for resolution funding in order to reap economies of scale. If the DGS is not allowed to be used for resolution, a resolution fund should be created.

In the case of cross-border banking groups, ***resolution colleges*** should be established, with clearly designated leadership. The European Banking Authority (EBA) should be member of the resolution college. The EBA would facilitate cooperation between authorities, and mediate, if necessary. By definition, the development of resolution plans and the decision on resolution measures would be the responsibility of the resolution colleges.

The proposed Directive supports cooperation with third country authorities in the resolution of banks/banking groups established in ***third countries***, provided the foreign resolution action ensures fair and equal treatment for local depositors and creditors and does not jeopardise financial stability in the member state. The EBA should develop framework arrangements with third countries and national authorities should conclude bilateral agreements in line with the EBA's framework arrangements.

According to the European Commission's proposal, the Directive should be transposed into national law by ***December 31, 2014***. The provisions on the bail-in tool should be applied from January 1, 2018 (this date takes into account the observed maturity cycles of existing debt and the need to avoid deleveraging).

II.3 European Commission memo on the creation of a European banking union

Concurrently with its proposal for a bank resolution framework, the European Commission issued a memo on the creation of a European banking union.

The proposed banking union would rest on four pillars:

1. a single EU supervisor with ultimate decision-making powers in relation to systemic and cross border banks,
2. a single European deposit guarantee scheme covering all EU banks,
3. a common resolution authority and a common resolution fund,
4. a uniform single rulebook for the prudential supervision of all banks.

The European banking union would commence operations as of January 1, 2013 and be funded from taxes/levies imposed on banks.

The first step in establishing the European banking union would be the creation of a single European supervisor. Here, two options are considered:

- Transforming the EBA into an independent authority to supervise all EU banks. This would require an amendment to the Lisbon Treaty.
- Large European bank groups would be supervised by the European Central Bank. This is possible under the Lisbon Treaty, subject to approval by all member states and the European Parliament.

The creation of a single European deposit guarantee scheme does not seem realistic in the short-term, and the same is the case with the proposed single rulebook. The debates over CRD4/CRR have shown that the application of a single European rulebook would also be difficult due to member states' insistence on national flexibility. The eurozone countries are perhaps more committed to the single rulebook.

II.4 Review of the Financial Conglomerates Directive (FICOD)

In April, the European Commission issued a call for technical advice from the Joint Committee of the European Supervisory Authorities' Subcommittee on Financial Conglomerates (JCFC). The Commission seeks the supervisory community's views regarding the efficiency of the prudential regulatory framework, in particular, the Financial Conglomerates Directive, including the multiple use of capital, group risks and regulatory arbitrage. The Commission requested the JCFC-t to assess the current legislation against international experience and developments with regard to:

- its scope of application, in particular, the inclusion of non-regulated entities,
- internal governance requirements and sanctions, in particular, obligations of the parent company,
- supervisory powers, particularly in the case where the parent company is a non-regulated holding company.

In its response to the Call for Advice, the European Banking Federation pointed out that the entities within a financial conglomerate, although not regulated, are subject to group supervision on a sectoral basis, hence, there seems to be no regulatory gap to be filled to include non-regulated group members in the supervision. However, should there be any entity in a financial conglomerate that is not subject to supervision, the issue should be looked into under the proposed legislation on shadow banking.

The Joint Committee launched a three-month joint consultation on its proposed response to European Commission. In its response, the Joint Committee puts forward a series of recommendations, including the widening of the scope of supervision, the addressing of requirements and responsibilities to a designated entity within the financial conglomerate, and the framework of supervisory powers provided by the FICOD.

The Joint Committee will provide further supervisory input to the wider fundamental review of FICOD later during this year.

III. European Banking Authority (EBA)- European Supervisory Authorities (ESAs)

III.1 Report on the Basel III monitoring exercise

In April, the EBA published a first report on the results of the Basel III monitoring exercise, as a follow-up to the comprehensive European quantitative impact study (EU QIS) conducted to analyse the impacts of the new requirements in December 2010. The report is based on consolidated data of 158 European banks as of 30 June 2011. The monitoring exercise provides an impact assessment of changes to banks' capital ratios under Basel III. The exercise is carried out by assuming full implementation of the Basel framework, no EU specific rules are analysed. The monitoring exercise is based on static balance sheet assumptions. Planned management actions to increase capital or decrease risk-weighted assets are not taken into account. As a consequence, monitoring results are not comparable to industry estimates. Also, the results are not comparable to the EU-QIS results, which assessed the impact of policy proposals published in 2009 that differed significantly from the final Basel III framework**.**

For the purpose of the exercise banks were classified in Group 1 (48 banks) and Group 2 (110 banks), Group 1 banks being those with Tier 1 capital in excess of EUR 3 billion and internationally active. Assuming full implementation of the Basel III framework, the CET1 **capital ratios** of Group 1 banks decline from an average CET1 ratio of 10.2% to an average CET1 ratio of 6.5%. 80% of Group 1 banks would be at or above the 4.5% minimum, while 44% would be at or above 7.0% target level. The CET1 capital shortfall for Group 1 banks is EUR 18 billion at a minimum requirement of 4.5% and EUR 242 billion at a target level of 7.0% (including the G-SIB surcharge). As a point of reference, the sum of profits after tax prior to distributions across the Group 1 sample in the second half of 2010 and the first half of 2011 was EUR 102 billion. For Group 2 banks, the average CET1 ratio declines from 9.8% to 6.8% under Basel III, where 87% of the banks would be at or above the 4.5% minimum and 72% would be at or above the 7.0% target level. The respective CET1 shortfall is approx. EUR 11 billion at a minimum requirement of 4.5% and EUR 35 billion at a target level of 7.0%. The sum of profits after tax prior to distributions across the Group 2 sample in the second half of 2010 and the first half of 2011 was EUR 17 billion.
For Group 1 banks, the overall impact on the CET1 ratio can be attributed in almost equal parts to changes in the definition of capital and to changes related to the calculation of risk-weighted assets: while CET1 declines by 22.7%, RWA increase by 21.2%, on average. For Group 2 banks, while the change in the definition of capital results in a decline in CET1 of 25.9%, the new rules on RWA affect Group 2 banks far less (+6.9%), which may be explained by the fact that these banks´ business models are less reliant on exposures to counterparty and market risks (which are the main drivers of the RWA increase under the new framework).

Monitoring results indicate a positive correlation between bank size and the level of leverage, since the average **leverage ratio** is significantly lower for Group 1 banks. Group 1 banks show an average Basel III Tier 1 leverage ratio of 2.7%, while Group 2 banks' leverage ratio is 3.4%. 41% of Group 1 and 72% of Group 2 banks would meet the 3% target level as of June 2011. If a hypothetical current leverage ratio was already in place, the leverage ratio of Group 1 and Group 2 banks would be 4.0% and 4.7%, respectively.
As for liquidity standards, there is no significant difference between the Liquidity Coverage Ratios (LCR) of the two groups. Group 1 banks reported an average LCR of 71%, while the average LCR for Group 2 banks is 70%. The aggregate Group 1 and Group 2 shortfall of liquid assets is at approximately EUR 1.2 trillion which represents 3.7% of the approximately EUR 31 trillion total assets of the aggregate sample. Group 1 banks reported an average Net Stable funding Ratio (NSFR) of 89% (Group 2 banks: 90%). To fulfil the minimum standard of 100% on a total basis, banks need stable funding of approximately EUR 1.9 trillion.

III.2 EBA questionnaire on the identification of user/investor needs on credit institutions' Pillar 3 disclosures

In April, the EBA issued a brief questionnaire to identify user/investor needs under Pillar 3 disclosures. Pillar 3 disclosures are often criticised for being overly focused on regulatory needs. Ahead of its usual annual assessment, the EBA sought to identify those pieces of information that users consider to be particularly relevant and useful. The questions were related to the best practices identified by the EBA in the previous assessments. In addition to the identification of the respondents, they included questions regarding the respondent's general perception of the usefulness of Pillar 3 disclosures and its specific needs concerning the information on own funds, the IRB approaches, securitisation, remuneration and market risks. The EBA published the responses on its website on May 8.

III.3 Consultation on draft Regulatory Technical Standards (RTS) on own funds (CP/2002/02)

In accordance with its mandates under the CRD4/CRR, the EBA develops and issues for consultation draft regulatory and implementation standards. (These standards are mandatory and part of the Single European Rulebook). Accordingly, in April the EBA published for consultation the first part of its RTS on own funds (14 Regulatory Technical Standards related to 14 articles of the CRR). The consultation ran until July 4. The proposed standards in particular covered the following areas: Common Equity Tier 1 capital (CET1), additional Tier 1 capital, deductions from Tier 1 capital, and general requirements and transitional provisions (grandfathering).

The EBA will adjust the proposed standards to take account of the comments received and the final text of the CRR. Then, the proposal will be submitted to the European Commission. The proposed RTS are expected to enter into force concurrently with the CRD4/CRR, on January 1, 2013.

III.4 Survey on the implementation of the Guidelines on remuneration policies and practices

These guidelines, developed by the CEBS, the EBA's predecessor, had to be applied from January 1, 2011, concurrently with the relevant provisions of CRD3. The EBA published the results of its survey in April. The survey's findings indicate that in most countries the Guidelines came into force on January 1, 2011 and that supervisors have actively assessed remuneration policies requiring, where needed, interventions in the remuneration structures and payouts of the variable component. Institution have made significant progress in the governance of remuneration. However, considerable variations exist in the extent to which the remuneration requirements are applied beyond the scope of the CRD. The survey has highlighted inconsistencies across institutions in the identification of staff that have a material impact on the risk profile of the institution. Inconsistencies have also emerged in the application of the proportionality principle varying from predetermined fixed criteria to case-by-case approaches to determine if the set of specific remuneration rules should be applied to identified staff. The survey has shown that risk alignment practices

across the industry are underdeveloped, namely with regard to the interaction of parameters used for risk management and the structure of bonus pools.
In light of the shortcomings identified by the survey, the EBA welcomes the proposal to widen the scope of the mandate for the EBA to develop criteria to identify categories of staff whose professional activities have a material impact on the institution's risk profile.

III.5 Consultation on draft guidelines on the assessment of the suitability of members of the management body and key function holders (CP/2012/03)

Based on the lessons learnt from the financial crisis, in April the EBA launched a consultation on the assessment of the suitability of members of the management body and key function holders. The proposed guidelines set out the process, criteria and minimum requirements for assessing the suitability of these persons, to be followed by both credit institutions and competent authorities. The guidelines set out the criteria for the assessment and documentation requirements for institutions. They also contain a notification requirement and provide that in cases where a member of the management body is not suitable, the credit institution and, if necessary, the competent authority shall take appropriate action. In order to ensure robust governance arrangements and appropriate oversight, the scope of the proposed Guidelines is not limited to members of the management body but extends to members of the supervisory function (external board members) and to key function holders. Financial and mixed financial holding companies are also subject to the guidelines.
(The consultation ran until June 18. A public hearing was held on June 1).

III.6 Report on the fulfilment of the EBA recapitalisation recommendation of July 15, 2011

Following the publication of the 2011 EU-wide stress test results in July 2011, the EBA issued a Recommendation to national supervisory authorities to ensure that appropriate mitigating actions were put in place with respect to (i) banks with a Core Tier 1 capital (CT1) ratio below 5% in the adverse scenario and (ii) banks with a CT1 ratio close to 5% in the adverse scenario and with sizeable exposures to sovereigns under stress.[3] National supervisory Authorities responsible for the supervision of the banks falling under the scope of the EBA Recommendation have provided the details of the mitigating measures taken for the respective banks and of their close monitoring of banks as a part of ongoing supervisory activities. (Banks were required to raise their Core Tier 1 capital ratio to 9%).

In its report of *May 2, 2012*, the EBA expresses its satisfaction with the progress made in the fulfilment of the July 2011 Recommendation, noting that the actions taken include capital strengthening and adequate recognition of losses. In addition, those banks identified as having weaknesses have subsequently undergone restructuring processes and will no longer exist in the same form as at the moment of the stress test.
The EBA will continue to monitor and assess risks and vulnerabilities from a microprudential perspective in the EU banking sector by employing a wide range of tools. The EBA is currently developing its approach to the next EU-wide stress test exercise to take place in 2013.

According to the EBA's update of *July 11*:

- The exercise led to an aggregate EUR 94.4 billion recapitalisation for 27 banks (largely exceeding the EUR 76 billion shortfall identified in December) and to a significant restructuring of the remaining 4 banks.
- Compliance with the Recommendation has been achieved mainly via measures which have a direct impact on capital (retained earnings, new equity, and liability management), with an amount of EUR 71.6 billion representing 95% of the initial shortfall and 76% of the total measures.
- In line with the Recommendation, the exercise did not lead to reduced lending to households and corporates or to fire sales of assets. The deleveraging measures agreed as part of the capital plans led

[3] The EBA reaffirmed these recommendations in December 2011. (See our relevant quarterly report).

to an overall reduction of risk weighted assets (RWAs) by only 0.62% compared with the September 2011 aggregate RWAs. Moreover, those measures were concentrated on a small number of banks that have agreed this reduction with international and EU organisations within the framework of formal restructuring and state aid.

The EBA and the national supervisors will continue to monitor the fulfilment of the Recommendation for all banks included in the sample. Where necessary, national supervisors may undertake a detailed review of individual bank's asset quality to better understand the risks underlying banks' capital positions.

III.7 Consultation paper on a template for recovery plans

On May 15, the EBA published for consultation a discussion paper on a proposed template for recovery plans to cover the essential issues that should be addressed in a recovery plan. The inputs from the discussion process will assist the EBA in the performance of its role according to Article 25 of the EBA Regulation, assigning the EBA the task of contributing to and actively participating in the development and coordination of effective and consistent Recovery and Resolution Plans (RRPs), identifying best practices, and drafting regulatory and implementing technical standards with regard to the development of RRPs. The discussion paper presents the EBA's preliminary views and should not be considered as a formal opinion. Pursuant to the proposal, a recovery plan should include the following three main chapters:

1. General overview
    - Summary of the plan
    - Description of the group/institution
    - Discussion of internal governance
2. Core of the recovery plan
    - General overview of recovery options/measures
    - Recovery early warnings and triggers
    - Recovery measures
    - Operational contingency plan
    - Communications plan
    - Information management
3. Follow-up

In its response to the discussion paper, the EBF expressed its support of the concept and said the proposed template was well-balanced and in line with the FSB proposal. The EBF pointed out the following:

- European regulations should be consistent with global regulations,
- Group recovery plans should be the basis,
- Confidentiality is key,
- There should be a clear separation between recovery plans and resolution plans,
- Recovery plans should merely set out strategic option,
- The recovery plan should remain the responsibility of the bank's management,
- The recovery plan should take into account the principle of proportionality,
- Recovery plans should be designed in a prudent and flexible manner, in order to minimise the potential costs,
- Sufficient time should be allowed for the preparation of recovery plans. (The EBF estimates the need for a two-year implementation period after the final approval of the Crisis Management Directive).

III.8 EBA guidelines on stress VaR (GL/2012/2) and on IRC[4] (GL/2012/3)

[4] Incremental default and migration risk, commonly referred to as the Incremental Risk Capital Charge (IRC)

In May, the EBA published two technical guidelines in May: the guidelines on the calculation of stressed Value-at-Risk and the guidelines on the incremental default and migration risk charge (IRC).

The guidelines on stressed VaR apply to institutions using an Internal Model Approach for the purpose of calculating the capital requirement for market risk in the trading book. The main provisions of the guidelines relate to:

- the identification and the review of the stressed period;
- the Stressed VaR methodology;
- the use test.

The guidelines on IRC include provisions on the IRC modelling approaches applied by credit institutions using the Internal Model Approach for the calculation of the required capital for specific interest risk in the trading book. The incremental risk charge is intended to complement the VaR modelling framework. The main provisions of the IRC guidelines relate to:

- the scope of application; individual modelling of all aspects of the IRC approach,
- the interdependence between default and migration events,
- the profit and losses (P&L) valuation, including how rating changes impact market prices and the computation of P&L,
- the liquidity horizons (guidance on defining a liquidity horizon and on the monitoring of liquidity horizons),
- the validation and use test for IRC models.

III.9 Consultation on a Data Point Model (DPM) related to Implementing Technical Standards for supervisory reporting

On May 25, the EBA published a draft Data Point Model based on its draft Implementing Technical Standards (ITS) on supervisory reporting requirements for institutions (CP50 és CP51[5]). In order to assist uniform implementation of the ITS, the data items included in CP 50 and CP 51 have been translated into a Data Point Model (DPM**)**. The DPM is a structured representation of the data, identifying all the business concepts and relations as well as the validation rules. It contains all the relevant technical specifications necessary for developing an IT reporting solution. During the short consultation period (running until June 11), the EBA invited comments in particular on the semantic contents of the DPM, i.e. the proposed categorisation of the data points/template cells.

In its response, addressed to the EBA Executive Director, the EBF criticised the fact that

- the EBF gave an unprecedented short consultation deadline (11 business days), as opposed to the three months, or in special cases, six weeks, provided by the rules,
- the EBA plans to introduce additional reports (templates) over and above those contained in CP 50 and CP 51,
- the EBA did not solicit comments on issues not related to the semantic contents of the comments, thus ignoring such issues, which means that the critiques concerning the absence of rollout plans for the phase-in period are not taken into account.

In summary, the EBF pointed out that the proposal was inconsistent with the European Commission's better regulation concept and should be fundamentally revised. The revised proposal should be submitted for an at least six-week consultation.
Based on comments received from IT specialists, the EBF gave detailed comments on the consultation paper, reiterating the need for a new consultation.

[5] See our first quarter report.

III.10 Consultation on Draft Implementing Technical Standards (ITS) on disclosure for own funds (CP/2012/04)

The proposed ITS complement the regulatory technical standards on own funds published in April and focus on the disclosure requirements to be met by institutions. Establishing appropriate disclosure requirements increases the transparency on regulatory capital held by European institutions and contributes to strengthening its quality and quantity. The proposed technical standards aim at ensuring a uniform approach to disclosure for own funds by institutions and across jurisdictions in order to allow detailed assessments of banks' capital positions and to make cross-jurisdictional comparisons. To avoid the development of two different disclosure frameworks, the draft ITS follow closely the approach adopted by the Basel Committee and are consistent with COREP. Pursuant to the proposed ITS, institutions should complete three sets of template:

- a general own funds disclosure template reflecting the capital position of institutions;
- a transitional disclosure template covering the phasing in (from January 1, 2013 to December 30, 2017) of the regulatory adjustments – namely with reference to deductions and filters, and reflecting the transitional provisions implemented by the institutions;
- a template describing the main features of the institution's capital instruments.

In addition to the three templates, institutions are required to provide a balance sheet reconciliation between their financial statements and their regulatory own funds to address the disparities between these two sets of data.
(The consultation ran until July 31).

III.11 Consultation on Draft Implementing Technical Standards (ITS) on supervisory reporting requirements for liquidity coverage and stable funding (CP/2012/05)

These ITS are an addition to the draft ITS text proposed in the consultation paper on supervisory reporting for institutions (CP50) and should be read in conjunction with them. They specify the main features (formats, frequencies, IT solutions) of prudential reporting to be applied by financial institutions in Europe, aimed at providing authorities with harmonised information. The purpose of this short and long-term monitoring is two-fold: (i) to provide information for the economic impact assessment to be carried out by the EBA during the monitoring period, and (ii) to enable authorities to monitor institutions' compliance with the liquidity requirements once they have been introduced as binding minimum standards. The scope and level of application of the proposed ITS are in line with the Capital Requirements Regulation (CRR). The liquidity coverage reporting is to be done at least monthly and the stable funding reporting at least quarterly. A separate consultation on a data point model containing the relevant technical specifications for developing an IT reporting format will be published in the second half of 2012.
The CRR also mandates the EBA to develop additional liquidity monitoring metrics to provide authorities with a comprehensive view of institutions' liquidity risk profiles. The EBA is currently working on these metrics and will launch a public consultation in due course.
(The consultation on the proposed ITS ran until August 27. A public hearing was held on July 18).

III.12 Consultation on Draft Implementing Technical Standards (ITS) on supervisory reporting requirements for the leverage ratio (CP/2012/06)

In parallel with its proposed ITS on liquidity ratios, the EBA published for consultation its proposed ITS on supervisory reporting requirements for the leverage ratio. The proposed ITS will be part of the general reporting framework. They complement the draft ITS contained in CP50, published in December, and should be read in conjunction with them. The proposed ITS will serve for the final calibration of the leverage ratio by the EBA and allow authorities to assess compliance. The ITS have been developed based

on the template used for the Quantitative Impact Study by the Basel Committee and on the COREP and FINREP guidelines. The new reporting requirements will take effect on January 1, 2013.
(A public hearing on the proposal was held on July 18. the consultation ran until August 27.)

III.13 Consultation on Regulatory Technical Standards (RTS) on the concept of Gain on Sale associated with future margin income in a securitisation context (CP/2012/07)

Article 29 of the proposed Capital Requirements Regulation (CRR) provides, as a general principle, that institutions shall exclude from their own funds increases in equity resulting from the sale of the assets being transferred in a securitisation transaction. This principle was already included in Directive 2006/48 (CRD II). The concept of gain on sale is mainly relevant for financial institutions applying the US GAAP.
Based on the mandate provided in the CRR, the RTS describes the relationship between gain on sale and future margin income. Under the consultation, the EBA requested answers to the following questions:

- whether the definition for future margin income as provided in Article 237 of the CRR is adequate, or an alternative definition would be more appropriate;
- whether Article 9 of the CRR captures and adequately specifies the concept of gain on sales;
- whether Article 9 of the CRR results in any incremental costs or benefits;

(The consultation ran until August 12. A public hearing was held on June 28).

III.14 Consultation on Draft Regulatory Technical Standards (RTS) on the capital requirements for central counterparties (CP/2012/08)

On June 15, the EBA published for consultation its proposed Regulatory Technical Standards (RTS) on the capital requirements for central counterparties (CCPs). The proposed RTS are consistent with the Regulation on OTC derivative transactions, central counterparties and trade repositories (EMIR). The EMIR Regulation requires CCPs to collect margins, to maintain a pre-funded default fund and to maintain dedicated own resources to cover potential losses upon default of any of their clearing members. The proposed RTS specify the related capital requirements. The RTS require a CCP to hold capital, including retained earnings and reserves, that is at all times at least equal to the sum of: (i) its operational expenses during an appropriate time span for winding-down or restructuring its activities, (ii) its capital requirements for the overall operational risk, and (iii) its capital requirements for credit, counterparty credit and market risks stemming from non-covered activities it carries out.
The consultation ran until July 31, 2012. The final RTS are expected to be submitted to the European Commission by September 30 for adoption.

The European Supervisory Authorities requested the European Commission to extend the deadline for the drafting of RTS on the mitigation of risks on non-centrally cleared OTC derivatives transactions, also related to the EMIR Regulation

IV. European Banking Federation - IBFed

IV.1 Capital requirements regulations (CRD4/CRR)

IV.1.1 Latest developments

The European Parliament and the Council had developed their own positions on the proposed CRD4/CRR, and the trilogue commenced in May[6].

As opposed to the single European rulebook, the tabled proposals would give member states more freedom and flexibility in three areas:

[6] The third party to the trilogue is the European Commission

1. Systemic risk buffers: pursuant to the Council's proposal, a systemic risk buffer of up to 5% of risk weighted assets would be a national discretion, that above 5% would be subject to Commission approval. The Internal Market Commissioner Michele Barnier proposes a systemic risk buffer of up to 3% to be a national discretion, with an additional risk buffer of up to 2% to be allowed for domestic exposures and a risk buffer for third country exposures to be agreed between home and host supervisors.
2. Macroprudential supervision: member states may introduce macroprudential measures subject to notification to the Commission, the EBA and the European Systemic Risk board (ESRB), specifying the risk to be mitigated and explaining why that risk cannot be managed through other provisions of the CRR.[7]
3. The European Commission's power to adopt delegated acts: this power would be limited to risks affecting the EU as a whole. Mr Barnier considers this proposal to be too restrictive. He believes that the Commission should be authorised to adopt delegated acts if at least three countries are affected.

Developments related to the EBF's top ten priorities:

- Broader recognition of minority interests at the group level (capital conservation and countercyclical buffers, additional capital requirements under Pillar 2, systemic risk buffer). This would allow the recognition of EUR 30 billion in capital at the European level.
- The Basel I floor will probably remain: neither the European Parliament, nor the council supports its abolition.
- The scope of eligible liquid assets will be widened, the 75% runoff factor for corporate deposits will be reduced (with the definitions and discounts to be determined by the EBA).
  Views diverge regarding the use of liquid assets for operating purposes. Some members want the liquidity buffer to be separate, some MEPs want a more flexible buffer.
- Automatic exemption from application at the solo level, as limited by the powers of the host supervision.
- The European Parliament wants a preferential weighting for SMEs, the Council does not support this (may be for negotiation reasons). A decision may be adopted during the trilogue.
- The Commission does not support the uniform treatment of software. Some MEPs submitted an amendment proposal for the deduction of software from capital. However, this proposal is not included in the latest compromise proposal.
- There is consensus that the leverage ratio should not be disclosed before its calibration is finalised. However, there is some pressure to shorten the deadline for final calibration.

Other focus issues for the EBF include the question of credit value adjustment and the deletion of the proposed amendments to the rules for remuneration. The weighting of available-for-sale portfolios, export credits and third country currency denominated government bonds was also raised as an issue.

Until the end of July, only the Directive had been discussed, the discussion of the CRR had not even begun. Then, it turned out that the Council had suspended the work on the new capital regulation, and the European Parliament had decided to vote on the package as late as in October. In view of the drawn-out trilogue, the EBIC[8] wrote a letter to decision makers, requesting them to postpone the implementation of CRD4/CRR to January 1, 2014. This is warranted by the time needed for the related IT developments and by the fact that banks can start preparations only once the final texts of the regulations have been adopted.

IV.1.2 EBF letter in support of the single European rulebook

[7] That is, through the internal model, supervisory measures in case of non-compliance, additional capital requirements, national systemic risk buffers and countercyclical buffers.

[8] European Banking Industry Committee: the joint committee of European industry associations

Ahead of the May 2, 2012 ECOFIN[9] meeting, the EBF wrote a letter to national banking association, requesting them to lobby with their finance ministers (by using the arguments of the EBF) for a single European rulebook.

Also, ahead of the May 15 meeting of ECOFIN, the EBF's president Christian Clausen wrote a letter to the Internal Market Commissioner, copied to the ECOFIN, the ESRB and the EBA, reiterating the EBF's support of a single European rulebook. The proposal tabled by the European Council leaves the decision on the presence of a macroeconomic or systemic risk to national discretion. In the EBF's view, however, the announcement by the member state in question should be preceded by a joint ex-ante verification by the European Commission, the ESRB and the EBA. Although macroprudential supervision is a new and developing area, the European supervisory system should be capable of managing systemic risks without introducing a new national discretion. Also, while EU regulators should follow the global standards, this is contradicted by the Danish Presidency's compromise proposal for a systemic risk buffer of up to and above 3%. This is premature and pre-empts the relevant international regulation. With the ever-increasing capital adequacy requirements, bank's lending capacity is coming under increased pressure.

IV.1.3 Study on the risk weighting of retail mortgage loans

The EBF Risk Assessment Working Group conducted a study among 42 IRB banks (including 3 Hungarian banks) on the risk weighting of retail mortgage loans
Mortgage lending is the main risk-taking area for European banks. Mortgage loans make up 23% of all loans and 75% of all retail loans. Notwithstanding, the mortgage indebtedness of households is low (although varying by member state). The European Regulatory framework makes mortgages (in some cases due to the insurance and guarantee systems) a relatively secure asset class. The originate-to-hold model is typical, which basically explains the difference in average risk weights from other jurisdictions. The retail mortgage markets differ even within Europe, which is clearly reflected in the difference in risk weights.

The study provides the following conclusions and recommendations:

- The principles of risk measurement should be respected.
- Direct comparisons should be avoided.
- Sound underlying statistics are of great value.
- Joint assessment by the home and host supervisors is key.
- Consistency over uniformity.
- Supervisory convergence does not rule out the choice of individual models.

The study has identified those areas, where convergence in practices would be desirable (adjustment for cyclicality, downturn LGD, LGD modelling, LGD cap) and those, where significant differences exist (history, definition of non-compliance).

IV.1.4 Treatment of trade finance

The EBF and other trade associations wrote a joint letter to the European Council, drawing attention to the unintended consequences of the treatment of trade and export finance instruments under the CRD4/CRR. The proposed regulatory framework does not reflect the actual risks in these instruments and fails to take account of the adverse impact the proposed changes would have on European trade and the real economy.

(To address the issue, the current CRR text provides for a 20% risk reduction factor for off-balance-sheet assets related to trade finance).

IV.1.5 Treatment of available-for-sale portfolios (AFS)

[9] The council of EU finance ministers

IAS 39 provides for the recognition of available-for-sale instruments at fair value and the presentation of changes in fair value, as a component of equity. This category will be eliminated under IFRS 9, expected to be applied from 2015. Under the CRR proposal, from 2013, unrealised gains or losses from changes in the fair value of AFS instruments will be required to be recognised in equity. The inconsistent implementation dates of the two regulations entail undesired consequences. To solve this problem, the EBF proposed the adoption of a uniform solution for the offsetting of gains or losses from changes in the fair value of AFS instruments in equity until the entry into force of IFRS 9 (Article 30 of the CRR should be amended accordingly).

IV.2 EBF developments regarding the High-Level Expert Group on reforming the structure of the EU banking sector (Liikanen group[10])

The EBF task force on the issue, assisted by consultants, is working proactively in trying to prepare for the Liikanen group's proposals. In the EBF's view, the possible structural reforms are likely to be counterproductive by being unnecessary, negatively impacting growth, and potentially undermining the benefits of the Single Market by restricting cross-border activities.

Instead, the EBF proposes the completion of an EU-wide crisis management framework and the strengthening of macroprudential oversight. The adoption of a harmonised regime for crisis management should be at the heart of enhanced European supervisory cooperation.

A possible structural reform is not a viable solution for the European banking sector, since it does not address the European Commission's objectives of risk reduction and enhanced resolvability. Structural reforms would increase the overall risk of the sector and negatively impact the EU market structure, and thus, hamper the objective of banks serving the real economy and harm the functioning of the Single Market. Instead, the G20/EU regulatory package already on the table (although far from being completed), that is: stronger prudential requirements, enhanced supervision (micro and macro), an appropriate crisis management framework (including bail-in), would be a more targeted solution for the EU Commission's objectives, without negative impacts on the European economy and single market.

In a press release in May, the EBF reiterated its view that an unnecessary and ill-thought-out reform would impair and dismantle the benefits of financial integration achieved to date.

In connection with the Liikanen group's work, the European Commission conducted a consultation seeking the views of banks, businesses and consumers on the possible structural reforms. The EBF gave a detailed answer, reiterating that there was no need for structural reforms.

IV.3 Shadow banking

In its response to the European Commission Green Paper on shadow banking[11], the EBF pointed out the following:

- The shadow banking entities and activities identified by the FSB and the European Commission are often key customers and sources of funding for banks. Therefore, the final policy recommendations should take into account the global impact on the ability of banks to provide finance to their customers and the real economy. Given the current financial and economic fragility, it is imperative that the current level and diversity of funding is increased or at least maintained and that interlinkages are properly understood.
- Securitisation needs to be reinstated to support funding of the real economy.
- A better definition and description of shadow banking is required.

[10] As reported in our first quarter report, the European Commission has set up of a High Level Expert Group on reforming the structure of the EU banking sector. The Expert Group is led by the Governor of the Bank of Finland, Erkki Liikanen.
[11] See our first quarter report.

- A stocktaking of regulatory initiatives needs to be undertaken first.
- Use macro-prudential supervision (the European Systemic Risk Board) to monitor risks.
- Europe should contribute to the FSB work and wait for this to be finalised before starting its own projects.
- Unintended consequences should be avoided.
- A level playing field should be ensured.

IV.4 Reporting requirements

1. The EBF organised a reporting roundtable in early spring. The roundtable was attended by representatives from the European Commission, the EBA, the ECB and the European Systemic Risk Board. The EBF considered the roundtable successful in that

- the industry had the chance to present to the EU authorities its concerns over the various regulatory initiatives in process, drawing attention to the importance of an integrated approach and of the justification of the need for the various reports and pointing out the need for the establishment of a permanent communication channel for the industry,
- the industry had the chance to present its concerns regarding CP50,
- the authorities have realised the operational challenges and risks posed by the torrent of reports expected from banks.

2. The European Systemic Risk Board requested large European banks to provide, by June 11, non-aggregated individual data on their

(1) covered assets and innovative funds, and
(2) interbank exposures.

The first item is required for understanding banks' funding strategies, the second item is needed for assessing the interdependence of European financial markets.

IV.5 Trade associations' joint letter on extraterritorial legislation

Four global trade associations, the IBFed, the International Swaps and Derivatives Association (ISDA), the Global Financial Markets Association (GFMA) and the Financial Services Roundtable wrote a joint letter to the EU Internal Market Commissioner ahead of the G20 finance ministers meeting, drawing attention to the problems in extraterritorial legislation, including the ensuing difficulties in both interpretation and practice. The signatories pointed out the following main concerns:

- Duplicative requirements;
- Incompatible or conflicting requirements;
- Distortion of competition/reduction of customer choice;
- Unintended impact on clients/counterparties who are not directly subject to regulation;
- Lack of process for mutual recognition or comparability; and
- Regulatory uncertainty and disproportionate compliance burden.

Among the problematic instances of extraterritorial legislation, the signatories mentioned the Dodd-Frank Act (including the Volcker rule), the Foreign Account Tax Compliance Act (FATCA), the Markets in Financial Instruments Directive (MIFID) and the European Market Infrastructure Regulation (EMIR). The signatories proposed practical solutions to be used in the legislative process, including the preparation of global impact assessments; mutual recognition (or exemptive relief for certain activities), and targeted rules convergence.

IV.6 EBIC letter on Credit Rating Agencies

The EBIC wrote a letter to European officials ahead of the proposed revision of the Regulation 1060/2009/EC on Credit Rating Agencies. In its letter, the EBIC welcomes the objective to further enhance the regulation of CRAs, including the measures designed to reduce the risk of conflicts of interest and the measures aimed at enhancing the quality and transparency of ratings. However, the EBIC fears that some of the European Commission's proposals might be contradictory to these goals. The EBIC does not support a mandatory rotation of rating agencies as proposed by the Commission, as it would increase rating volatility, prevent the achievement of consistent rating histories and would not help to break up the oligopoly in the rating market. Also, the EBIC does not support the introduction of a civil liability regime, as it would be contrary to the objective of reducing investor reliance on ratings. As for structured products, the EBIC believes that the proposed double rating requirement is unnecessary. In relation to rating methodologies, the EBIC's view is that the ESMA's role should be restricted to verifying that any material changes to rating methodologies have been notified by a credit rating agency in accordance with the relevant provisions of the regulation. The EBIC supports the tabled amendments that would eliminate the problem of the endorsement of third country ratings once and for all.

IV.7 IBFed letter ahead of the meeting of the G20 leaders in Los Cabos

The EBFed wrote letter to the Financial Stability Board on the regulatory reform programme coordinated by the FSB, ahead of the G20 summit in Los Cabos. In its letter, the IBFed reviews the progress made and urges for the creation of effective resolution regimes. At the same time, the IBFed points out that the sheer volume of the additional proposed regulatory reform measures underway is undermining the quality and consistency of regulation. The IBFed believes that both the industry and the regulatory community would benefit if the FSB took steps to develop policies and processes which provide adequate time for stakeholder consultation. The IBFed expresses its concern that there is a growing tendency for regulation to be produced in silos, which reduces consistency and gives rise to potential harmful interactions. The IBFed also points out that stress in the financial system is being exacerbated by the growing tendency towards national regulators foreshortening implementation deadlines, whereas a regulatory race should be avoided. Finally, the IBFed expresses its support of the creation of consultative groups to promote international financial stability.

B) EU-WIDE FINANCIAL TRANSACTION TAX

In the second quarter, at the request of the European Council, the Danish presidency presented a status report to the ECOFIN's meeting of June 22. The report confirms the Commission's objective to impose an EU-wide Financial Transaction Tax. Member states agree that the sector should contribute to public finances. However, fewer support the idea for such contribution to be a funding source for the EU budget. Member states are divided over the question of whether an EU-wide FTT could reduce undesired transactions and over the potential impacts of a Financial Transaction Tax on employment and growth.

Those supporting the proposed tax are in favour of taxation at the place of the transaction, however, with a view to avoiding tax evasion they would agree to taxation at the place of the issuer.

Member states' views differ regarding the tax base. The exemption of repo and government bond transactions or the extension of the FTT to these transactions at a later stage is supported by many, as is the extension of the FTT to derivatives at a later stage.

Member states question the efficiency of the FTT regarding high-frequency and speculative transactions. They say that in these cases, direct regulation would be more efficient.

As for the tax rate, member states see a need for more technical assessments.

While technical assessments on the proposed FTT are in process, the Danish presidency has proposed that the Council should consider alternatives to the FTT, such as a narrow transaction tax to be imposed only on secondary market transactions with shares and corporate bonds, a review of the VAT exemption of financial services, introduction of a tax on bank' profits or payroll, or a levy on liabilities or other balance sheet items (the latter already applied in a number of member states).