HUNGARIAN BANKING ASSOCIATION

REPORT
on Activities of the Hungarian Banking Association
3rd Quarter 2012

Budapest, October 2012

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Executive Summary

The operating environment for banks did not improve in the third quarter, with no positive shift in the global economy. Growth in the USA is slower than expected and has slowed by 1.8 percentage points (from 1.5% to -0.3%) in the euro-zone. GDP growth in India and China has also slowed. Although a number of forward-looking crisis management measures have been taken in Europe, the situation of the PIIGS countries is still uncertain in terms of a lasting solution. Marked measures by national central banks have brought some temporary calm to the international financial market. The Hungarian economy's GDP production decreased in 2012 QI and QII compared to the previous quarter. Industrial sales have stagnated since mid-2010, investments and households' consumption have declined. The nominal (net) volume of loans in the banking sector fell significantly. In the past 24 months, corporate and retail loans dropped by 14.8% and 19.2%, respectively. In ROA, as a decade-long trend, the decrease in interest and non-interest income is offset by the decrease in operating expenses, and so, ROA is primarily determined by impairments and provisions and other non-interest income (inclusive of the special bank tax). ROE in the banking sector fell from above 20% in 2006 to -10% by the end of 2011. It was around 0% in the first half of 2012. The HUF/CHF és HUF/EUR exchange rates have had a significant impact on the volume of impairments. The indebtedness and the level of development of a country together determine a) the movement of exchange rates; b) the yields on government bonds and c) the stock exchange index. At a lower level of development, the same level of indebtedness will result in higher CDS spreads, a weaker exchange rate, higher yields on government bonds and a lower stock exchange index. The only way to break out is through growth.

Banks' operating conditions were influenced by a number of government measures and regulatory changes, including the entry into force of earlier adopted laws. One of the most important moves in the third quarter 2012 was the government proposal for a Financial Transaction Levy. The relevant law was adopted by Parliament on July 9. The Association developed its position on the FTL after several expert-level consultations. While consultations with the government were in process, the financial government announced that the general financial transaction levy rate would be increased from 0.1% to 0.2% and the bank tax would remain at the original level (contrary to the earlier promise to half it). Given that there had been no prior consultations with the Association before these announcement, these measures, if implemented, can be considered as a breach of the agreements made between the government and the Association in December 2011 and June 2012.

There were also major development regarding the legal environment. These included include:

- Proposed changes to the supervisory reporting in 2013, based on the requirements of the Hungarian financial Supervisory Authority (PSZÁF),
- Review and further development of PSZÁF's bank account choice project,
- amendments to the Anti-Money Laundering Act.

Banks' operations may be influenced in the long-term by the Supreme Court's working document on unilateral contract amendments. The Supreme Court has set up an analysis group to examine the case law of courts in judging whether the provisions on the unilateral amendment of contracts, as stipulated in financial institutions' general terms and conditions for consumer loans are unfair. The analysis group is charged with examining the case law of courts, the topics

to be examined are determined by the Supreme Court on an annual basis. Members of the analysis group include judges from the Supreme Court and Courts of Appeal. A researcher and an economist are also involved in the group's work. The analysis group has completed a working document and sent it for review to the Association and 18 other professional organisations and NGOs, including the MNB, the Chief Prosecutor, the Hungarian Financial Supervisory Authority, the Hungarian Bar Association and consumer organisations. The working document addresses the unilateral amendment of contracts for consumer loans other than home loans, that is, for home equity loans and long-term consumer loans. Contracts may be unilaterally amended to the detriment of the consumer in respect of interest, charges and fees.

An important development in retail banking was the continuous increase in the take-up rate of the Exchange Rate Cap Scheme.

There were positive changes regarding the operations of the National Asset Management Company. In accordance with the agreement made between the government and the Association on December 15, 2012, the Act on the National Asset Management Company (Act CLXX of 2011) was amended as of June 20, 2012. Under this amendment, the number of properties that can be purchased by the NAMC until 2014 has been raised from 5,000 to 25,000. Pursuant to the December agreement, the NAMC may purchase the property irrespective of whether or not it has been included in the quota on forced sale. The eligibility criteria for offering the property for purchase by the NAMC were also relaxed and the government's regulatory flexibility increased by referring the definition of social need to a lower-level legislation (government decree). Pursuant to the relevant government decree, families with one child may also offer their home for purchase by the NAMC.

1. Economic environment

1.1. International environment, crisis management in the EU, slowdown in Hungary's most important trading partners

According to the IMF's forecast of July 2012, global GDP growth will decline by 0.4 percentage points, from 3.9% in 2011 to 3.4% in 2012. The GDP growth rate in the developed countries will fall from 1.6% to 1.4%, growing in the USA (although at a slower pace then the past 100 years' trend) and slowing in the euro-zone by 1.8 percentage points, from 1.5% to -0.3%, with a major decline in Italy and Spain. The GDP growth rate in the developing countries is expected to fall by 0.6 percentage points, from 6.2% to 5.6%, including in China by 1.2% and India by 1%. Global exports are forecast to decline by 2.1 percentage points, from 5.9% to 3.8%. According to the IMF, GDP will grow both in the developed countries and the developing countries in 2012 and 2013, and so will global exports. The EU will rebound from the recession and growth will pick up in China and India. China is a debt-free, fast-growing economy. However, its GDP growth rate of 14% is half that before the crisis. The estimated 5% growth in global exports is also very low: in 20 out of the past 30 years it grew faster than this pace.

GDP per capita in the USA grew by an annual 1.88% over the past 120 years, with the volume of loans rising twice as fast. Since, by all analyses, the capital-to-output ratio is below 4 and the recommended maximum LTV is 70%, the loan-to-capital ratio will soon reach its maximum 70% level, which may mean the end of credit-based growth. This is a concern not only for the USA: over the past 100 years, all important innovations have been implemented in the USA and nobody knows what will happen when credit-based growth is over.

Looking at the past 110 years, the USA stock exchange index on average stagnated for 17 years, then grew at a rate double the nominal GDP growth rate for 17 years. Based on this, the bull market should return by around 2015, but this is conditional upon the revival of lending. Apart from loans, money may flow into the economy from exports, but for this, the US trade deficit should be significantly reduced.

Looking at the five EU member states referred to as the PIIGS countries, the bankruptcy of Greece seems inevitable, as its ever-growing debt, slowing and shrinking economy and high budget deficit show. In contrast, Spain's economic indicators suggest that since its primary balance is not so high, it may overcome the debt crisis.

The other three PIIGS countries, Ireland, Italy and Portugal are in an in-between state between Greece, which will certainly default (unless rescued with another bail-out package) and Spain, which is struggling to avoid default. However, the indicators of these three countries are not very good and their CDS exposures is also influenced by their debt. With their current indicators, another global crisis might cripple all five countries.

The central idea of the analysis provided in the summer of 2012 by the American economist, Roubini, is that the second phase of the W-shaped recession will be devastating, because all the

Keynsian techniques have been used, and there are no new techniques available for the time being.

1.2. The macroeconomic situation in Hungary, recession, long-term negative and stagnant outlook

The Hungarian economy's GDP production decreased in 2012 QI and QII compared to the previous quarter.

Seasonally and calendar adjusted GDP volume indicators. Previous quarter = 100

	2011				**2012**	
	Q1	Q2	Q3	Q4	Q1	Q2
Total GDP (at purchase prices)	101.4	99.7	100.0	100.1	99.0	99.8

Source: Hungarian Statistical Office

GDP absorption declined in Q2 2012 year-on-year by 1.33%. Households' consumption dropped more (-1.64%), gross investment shrank dramatically (-9.54%). With stagnating imports, the only growth was seen in exports (2%).

The low growth in exports was a consequence, not a cause, of the recession: Germany's exports (previously rising at the same rate as those of Hungary) grew 5% faster in 2011 and 2012 than those of Hungary.

One reason for the decline may be the shrinking of capital: in 2009, the rate of investment dropped below the 20% level required for capital preservation. There were no sufficient corporate profits, EU fund allocations, net capital influx or real growth in corporate lending to feed investments. (Corporate loans fell by 4.4% at current prices and 14% net of exchange rate effects and inflation between June 2011 and June 2012).

Industrial production and sales were higher in June 2012 and lower in July 2012 than a year before. Overall, the volume of industrial production has stagnated since mid-2010.

The rate of employment is very low in Hungary (the third lowest in the EU). This is partly due to the fact that part-time employment is not widespread in Hungary (nor is it in any of the post-socialist countries). Hungary has the fourth lowest part-time employment rate in the EU. Employment in the public sector grew slightly in 2012, contributing to a 1% overall increase in employment, which, however, was not big enough to prevent recession.

The data and impacts analysed show that the reduction of debt through measures that reduce the economy's ability to grow is not a sustainable path. Retaining the bank tax in 2013 (contrary to the agreement made between the banking sector and the government) is not a good method to stop the recession that started in the first half of 2012. A better method would be to finance the current debt through an IMF arrangement and to switch to a (bank and investment-friendly) path that promotes GDP growth.

1.3. Performance of the Hungarian banking sector, facts H1 2012, forecasts for the year

The nominal (net) volume of loans in the banking sector has fallen significantly. In the past 24 months, corporate and retail loans have dropped by 14.8% and 19.2%, respectively.

The stock of loans net of exchange rate effects and inflation has dropped below the level it was in 2005. The average stock of loans net of exchange rate effects and inflation has decreased by a monthly 1.1% for 42 months. If this continues, the stock of loans in real terms will half by end-2017.

The stock of corporate loans net of exchange rate effects and inflation and GDP moved together between 1992 and 2012. Expressed in the form of a formula: GDP growth rate = 1.1%+(change in loans/3). For example, if the stock of corporate loans falls by 9%, then, based on figures of the past twenty years, GDP will fall by around 1.9%.

Capital adequacy: banks' capital adequacy ratio hit the bottom in 2006 (9.9%). Since then, it has been on the rise and was as high as 14.8% in June 2012. This would allow significant lending to the corporate sector, if banks' risk appetite were not reduced by the extra taxes levied on banks. The loans-to-deposits ratio has decreased since March 2009. It was 130% as of June 2012 and 120-116% as of the end of Q3 2012.

There is a threat of a debt trap if the yields on government bonds are lower than the nominal GDP growth rate. The nominal growth rate of the GDP could be exceeded by the yields on government bonds without increasing the debt ratio if the primary balance of the budget could compensate it (by increasing the tax burdens or decreasing public expenditures). In Portugal, Ireland, Italy, Greece, Spain and Hungary the 10 year yields of government bonds exceed the nominal growth rate of GDP. Experiences support the view that without the growth of corporate lending economic growth could hardly be imagined.

In ROA, as a decade-long trend, the decrease in interest and non-interest income is offset by the decrease in operating expenses, so, ROA is primarily determined by impairments and provisions and other non-interest income (inclusive of the special bank tax). ROE in the banking sector fell from above 20% in 2006 to -10% by the end of 2011. It was around 0% in the first half of 2012.

The HUF/CHF és HUF/EUR exchange rates have had a significant impact on the volume of impairments. The indebtedness and the level of development of a country together determine a) the movement of exchange rates; b) the yields on government bonds and c) the stock exchange index. At a lower level of development, the same level of indebtedness will result in higher CDS spreads, a weaker exchange rate, higher yields on government bonds and a lower stock exchange index. The only way to break out is through growth.

The experience of the past fifteen years shows that the volume of corporate loans in real terms increases when banks' real ROE is positive. Average ROE in the banking sector between 1994 and 2012 was as low as 3.18%. At the current volume of shareholders' equity this would be HUF 80 billion, which is around 33% of the sector's burden from the early repayment scheme and 67% of the annual extra tax levied on the sector.

2. Government measures affecting banks' operations

2.1. Retail banking

2.1.1. Experience of the Exchange Rate Gap Scheme, government guarantee for overflow accounts

a) The proposed Government Decree on government guarantees for overflow account loans was submitted for review at a time when these loans had already been disbursed. Under the normal banking procedure, a bank may set the availability of government guarantee as a condition for the provision of the overflow account loan. The Government Decree makes it the other way round. Nevertheless, given the long duration of the loan, it is the interest of banks to have an appropriate government guarantee facility in place.

Through several oral and written consultations, we managed to ensure that

- the starting date of the government guarantee is tied to the date of disbursement of the loan rather than the contract date (since the latter implies a number of uncertainties).
- the form to be used for the enforcement of the guarantee is adjusted to banks' requirements and practice,
- the base for the guarantee fee is made more specific (e.g., no fee should be charged on risks already transferred to the state, loans cancelled in the meantime should not be included in the fee base)

The review of the proposed Government Decree is still in process.

b) During the review, a number of issues requiring amendments to the relevant laws arose. The Association submitted its proposals, including detailed explanations, to the Ministry for National Economy. We proposed that

- the legislation should allow the enforcement of the guarantee during the exchange rate-capped period (due to an unintentional legal technical error, the current text does not allow for this).
- the debt converted from the overflow account loan into standard loan should be allowed to be added to the original loan, to avoid the unnecessary maintenance of small loans of a few thousand forints for 10-15 years.

The first proposal was accepted, the second is currently not supported by the Ministry.

2.1.2. National Asset Management Company (NET)

There were positive changes regarding the operations of the National Asset Management Company. In accordance with the agreement made between the government and the Association on December 15, 2012, the Act on the National Asset Management Company (Act CLXX of 2011) was amended as of June 20 2012. Pursuant to this amendment, the number of properties that can be purchased by the NAMC until 2014 has been raised from 5,000 to 25,000. Pursuant to the December agreement, the NAMC may purchase the property irrespective of whether or not it has been included in the quota on forced sale. The eligibility criteria for offering a property for purchase by the NAMC were also relaxed and the government's regulatory flexibility increased by referring the definition of social need to a lower-level legislation (government decree). Pursuant to the relevant government decree, families with one child may also offer their home for purchase by the NAMC.

The scheme started very slowly and the National Asset Management Company made some unjust statements putting the blame on banks for the slow process. The issue of helping debtors in

distress and the NAMC's operations were reviewed by the Dwelling Sub-Committee of the Parliament's Youth, Social, Family Affairs and Dwelling Committee.

With the new rules in place, the offering of properties for purchase by the NAMC began. According to information from the NAMC, 500 homes were offered for purchase as of the end of the third quarter. It is clear that the quota of 8,000 properties set for this year will not be exhausted. It is also true that banks have difficulties in getting hold of the customers: a criterion for eligibility is that the default is 180 days or more and these debtors in many cases have severed contact with their banks for months.

Another problem is that those employed in public work schemes (that is, those not receiving benefits) are not eligible.

2.1.3. Developments in the cards business

MALÉV's bankruptcy at the beginning of the year triggered an administrative process for refunding the cost of the air tickets to those having purchased their tickets by bank cards. The affected banks processed and started the chargeback process for thousands of claims. The task was rather complex, since a part of the customers had purchased their tickets through travel agencies. The refund process went smoothly and in accordance with the relevant rules of the international card schemes. The bulk of the refund claims had been processed by May, however, some individual claims may still occur before the end of this year.

A number of card-accepting banks have found themselves in a difficult situation with regard to the settlements with their travel agent partners. Given that in this case, the relevant bilateral contracts are governing, banks did not require the Association to take a common stance. However, the Association assisted the process by conducting consultations with the Association of Hungarian Travel Agents and Tour Operators (MUISZ) and by helping banks in communicating the actions required. According to press reports published in September, MUISZ reached agreement with the International Air Transport Association (IATA) on the refund by IATA of a significant amount in the range of HUF 405 to 600 billion for tickets purchased and not used. At a consultation on the issue, MUISZ indicated that one of MALÉV's large creditors had filed a lawsuit in the matter, therefore, the refund would probably not take place until the situation is clarified. At the same time, MUISZ confirmed its willingness to continue further consultations with the Association. Within this framework, joint actions are planned to avoid double refunds and the way may be opened up for restarting and accelerating the settlement process between the banks and travel agents involved.

Over the past months, the MNB has made several proposals to increase POS coverage in Hungary. According to the MNB's proposals, the required funding would be partly secured from EU funds and partly from contributions to be offered by market players. The Association is conducting continuous consultations with the MNB to ensure that banks' technical knowledge and experience is incorporated in the tender to be invited.

After the workshop held in the spring, at the request of the Ministry for National Development we organised a consultation with the Government IT Development Agency (KIFÜ) on the development plans for the Electronic Payments and Settlements System (EFER) in June. In its recent communications, the government has made clear its intention to increase the adoption of e-payments between government agencies.

2.1.4. VAT treatment of bank card services

The Association requested a ruling from the Ministry for National Economy on the VAT treatment of bank card services provided by card schemes. Substantiating the payment services nature of card services, we compiled and submitted to the Ministry an expert document on the process of bank card payments. According to our information, the Ministry is drafting a response in consultation with the Tax Authority.

2.2. Corporate lending

2.2.1. Short and long-term loans

According to the MNB's statistics, overdraft facilities play an increasingly important role in corporate lending. In the second quarter of 2012, the volume of overdraft facilities denominated in HUF and EUR rose by 6.5% and 20%, respectively. This indicates that companies' mainly borrow to finance their working capital needs and daily expenses, borrowing for investment projects is less significant. The ratio of investment to GDP keeps declining, falling from 22.5% in 2008 to 16% in 2012.

The deterioration of the quality of the SME loan portfolio continued in 2012. According to PSZÁF's statistics, only 60% of the loans are repaid on time and the NPL rate is more than 22% (in June 2011 its was "only" 17%). Small businesses are in the worst situation: their NPL rate is close to 29%.

The outlooks are not encouraging either, the terms and conditions for lending are expected to be further tightened in the following months. This mainly has to do with the grim economic outlook rather than the lending capacity of banks. Banks' lending capacity has improved compared to the previous quarter and they would be able to lend more, however, there is no appropriate demand at present.

2.2.2. Agricultural lending

Thanks to good agricultural year in 2011, apart from banks' reduced lending activity agricultural and food industry borrowings decreased also naturally in 2012 (loans were repaid from liquid funds). With the droughts in 2012, demand for loans is expected to rise again. The details as to how this demand will be managed are not known at this point.

An important development in the third quarter was the submission for public debate of the new Land Act. In the Association's view, in its current form, the draft law would make the financing of agricultural producers more difficult and increase credit risks. The proposed law for the most part provides common rules for the acquisition of land ownership and land use (lease). However, in many cases it fails to distinguish between the areas available for these two separate purposes. In addition to the approval powers of the agricultural authority, "local land committees" will be given review rights in respect of the contract price, the assessment of the contract from the point of view of land policy and the selection of the customer or lessee. The law is silent about the rules for the setting up and operation of land committees, whereas, pursuant to the proposal, they would have a decisive role. Due to the cap on land use and the uncertainty after

expiry of the current lease contracts (due to the changes in the land leasing system), access to finance by agricultural businesses will become more difficult.

Another important development in the third quarter was the review of the proposed amendments to the Warehousing Act. The Association reiterated the proposals it made 2 years ago.

In the past two years, warehousing loans continued to decrease, as also reflected in the decrease in the number of public warehouses and in the value of warehouse receipts. Due to their losses arising from deficiencies in the warehousing regulations, banks today assess a customer's application for working capital financing based on the customer's overall financial capacity and the independent collaterals provided for the loan. Warehouse receipts are not taken into account as a collateral at all, or if so, only as a comfort factor. Restoring banks' confidence in warehouse financing would allow banks to lend more against the same collateral, if it could be ensured that the products underlying the Warehouse Receipt are available at any point in time and are accessible in case of a liquidation proceeding.

2.2.3. Stimulating SME lending

As of March 12, the MNB has introduced a new instrument to stimulate lending. The central bank offers banks a 2-year refinancing loan against securities provided as collateral, at a variable interest rate equivalent to the central bank base rate at all times. Given that one of the reasons for banks' reduced lending activity is their limited lending capacity, the new instrument has not been very successful up until now.

Due to the adverse macroeconomic conditions, banks' corporate loan portfolios continued to fall in 2012. In view of this, as of October 1, the MNB has changed the criteria for the types and sizes of loans eligible for refinancing. Corporate refinancing loans, playing an increasingly important role in the economy, are now included as eligible, while loans for commercial real estates, involving growth and financial stability risks have been removed from the list of eligible loans. A new element is that the refinancing scheme is available for a maximum 50% of the bank's corporate loan portfolio.

2.3. Financial Transaction Levy

An important measure affecting banks in the third quarter was the submission to Parliament of the draft law on the introduction of a financial transaction levy effective 2013. The Act was passed by Parliament on July 9.

The text of the Act carried a number of interpretation uncertainties, which, due the political implications and the potential effects on banks' profits raised serious concerns among members. In July, the majority of members contacted the Association with questions and requested the Association to hold expert-level consultations on these interpretation issues. Accordingly, the Association approached the Ministry to eliminate these legal uncertainties.

Members held an expert-level consultation in early August. This was followed by a letter to the Ministry for National Economy, seeking a ruling from the Ministry. The letter contained all those issues in which the majority of members were able to develop a common position. The Association's negotiating team held an informal discussion with the Ministry's Deputy State Secretary responsible for taxation issues on the issues raised in the letter. The Deputy State Secretary gave

his position at the end of September by an unofficial letter to the negotiating team. Since most of the answers failed to provide clear legal interpretations, the Ministry offered the opportunity to hold expert-level consultations.

This consultation took place in the middle of October. In addition to reviewing the Ministry's position, the consultation addressed the initiation of an amendment to the Banking Act to ensure that banks can pass on the levy by including it in their business terms and conditions in a transparent manner.

While consultations with the government were in process, the financial government announced that the general financial transaction levy rate would be increased from 0.1% to 0.2%. Given that there had been no prior consultations with the Association on this plan, this measure, if implemented, can be considered as a breach of the agreements made between the government and the Association in December 2011 and June 2012.

2.4. Cap on FX swap portfolios

Due to the increase in banks' FX swap portfolios as of end-2011, since the first quarter of 2012 the MNB has been following closely the exchange rate effects and risks resulting from a high swap exposure. In its Financial Stability Report of April 2012, the MNB indicated that a regulation may be needed to mitigate the financial stability risks.

The central bank briefed the Association on its proposal for regulation at the Association's Extraordinary Board Meeting at the end of July. During this meeting, the MNB emphasised that although the issue could be solved by regulation, it would prefer banks to reduce their FX swap portfolios on a voluntary basis by self-regulation. The MNB explained the mechanisms causing the risk, showed the risk levels as calculated based on econometric models, and presented the concept of the proposed regulation. Since, according to the MNB, the critical threshold above which a spiral exchange rate effect would occur is EUR 10 to 12 billion, the MNB proposes to cap banks' open FX positions at 15% of total assets.

The Association set up a task force to review the mechanisms and the regulatory concept presented by the central bank. The task force is of the opinion that the central bank's concerns regarding the mechanism are exaggerated and the ratio presented for measuring the risk is unsuitable for determining the actual size of the risk, because it fails to take into account the risk-mitigating effect of swap exposures to parent banks and the difference between the risks in swap portfolios with short and long remaining maturities. The task force proposed that any regulation should be introduced with a 2 to 3-year implementation period. The Association communicated its position in a letter to the MNB in September.

In its response, while maintaining its position, the central bank said it would like to solve the situation through a self-regulation to be adopted by the banks. To achieve this, it drafted a sample declaration to be signed by each bank. The declaration contained a voluntary commitment by the signatory to comply with the above mentioned limit and a lead time for those banks exceeding the limit to adapt and comply by 2015.

A consultation on the Association's objections and the proposed self-regulation was held between the Association and MNB in the first week of October. As a result, the MNB made some adjustments to the sample declaration. The revised declaration is now being reviewed by members.

3. Legal environment

3.1. PSZÁF

3.1.1. Proposed PSZÁF recommendation on debt collection

PSZÁF drafted a recommendation on consumer protection principles to be applied by banks in the process of debt collection. The proposed recommendation is aimed to promote cooperation and fair conduct between banks and delinquent debtors. The recommendation would only apply to retail debtors. PSZÁF defines debt collection as activities aimed at enforcing past due claims from financial services provided on a commercial basis. The recommendation provides general principles for debt collection, including cooperation and fair conduct, due care, information provision, consideration of the debtor's financial capacity, and the principles of a step-by-step approach and regulated procedures. In addition to general principles, the recommendation provides best practices for debtor information and liaison and samples for information to be provided to the debtor in the case of repayment difficulties, in the pre-termination period and otherwise.

The recommendation fills a gap, since there is no regulation on debt collection in Hungary. The Association has urged for years for the development of legislation on debt collection, submitting detailed proposals to the legislators. PSZÁF has also drafted a regulatory proposal, the current recommendation is aimed at eliminating the shortcomings in this area until a regulation is put in place.

We reviewed the recommendation in several rounds with PSZÁF and provided comments ion it both orally and in writing. Many of our comments have been taken into account in the draft recommendation. According to banks, different procedures should be applied to customers who are cooperative and those who are non-cooperative or hiding. In this respect there is still a disagreement with PSZÁF. In our comments we drew attention to the inconsistencies in the legal framework, including issues related to data protection, the credit bureau legislation (which does not help, but rather, prevents banks from knowing the debtor's financial capacity), and the use of lawful databases.

3.1.2. PSZÁF bank account choice project

After conclusion of the consultations on the related reporting requirements and publication of the relevant supervisory decree, consultations between the Association and PSZÁF continued on issues related to the methodology for this service. Specialists from members banks involved in the consultation assisted in developing the appropriate customer profiles and parametering the various consumption habits. The service will offer various current account products and packages based on the consumption habit specified by the customer, allowing the customer to compare them based on the estimated average monthly fees.

The system is designed in a customer-friendly way. First, the customer will select a customer profile from six categories (e.g., young career-starter, active employee banking on a regular basis, etc.) Then, he will select a service (credit transfer, direct debit) and specify the method of using the service (bank card, e-channels).

Since current accounts are one of the most complex banking products, it is rather difficult to develop a method by which, if not all, but the vast majority of the services can be compared based on costs. It may also be a challenge how to include the various "associated services" in the comparison (for example: "if you keep your account with us, we will not charge you any loan disbursement fee"). Since the programme compares fees, it is a concern that products that otherwise can be flexibly adjusted to customer needs are necessarily simplified in the programme. Banks have 30 days to test the programme based on the uploaded products.

3.1.3. PSZÁF supervisory reporting requirements 2013

In our comments on PSZÁF's supervisory reporting requirements for 2013, we pointed out that the reporting requirements were changed year by year and meeting them imposed increasingly heavy burden on the sector. We explained that while we understood the reasons underlying the increased information requirements in view of the frequent and complex regulatory changes, the detailed guides provided earlier by PSZÁF are in many cases missing and the instructions accompanying the reporting requirements only cite the relevant provisions of legislation. We stressed that we would appreciate returning to the well-proven practice of PSZÁF providing the correlations between the various reporting tables to ensure transparency and troubleshooting. We emphasised that banks were sending a vast amount of information to PSZÁF and MNB on a regular basis, the number of regular and special reporting tables was continuously increasing and it was increasingly difficult to ensure the required checks before submitting the reports.

The planned changes would entail IT development needs and more work: while the special reporting tables introduced in 2012 (open and closed positions, account holders) became integral parts of the reports, the deadlines remained unchanged. We stressed that a three month implementation period should be allowed for any new reporting requirement.

We consider that the objectives of the government's Simple State Programme should also be applied to bank reporting by carrying out an overall comprehensive review of regulatory reporting requirements, including the cancellation of those not absolutely necessary. To achieve this, we wrote a letter to the President of PSZÁF and the Governor of the MNB, proposing expert-level negotiations to rationalise bank reporting requirements.

3.2. Regulation on branches of foreign companies

In the wake of the Supreme Court's Civil Law legal unity resolution No. 1/2012, the regulations on the status of financial branches of foreign companies registered in the EEA need to be amended. The Supreme Court's legal unity decision declares that a financial branch of a foreign company registered in the EEA (as per Act CXXXI of 1997 on Branches of Foreign-Registered Companies) cannot sue nor can be sued in Hungary (As is well-known, a financial branch is not an independent legal entity, it has no own assets and no capital requirements on foundation. It should be considered as an organisational unit registered in the domestic company registry as a branch of a foreign company).

This legal unity decision was required because the legal framework and the case law of courts was not consistent on the question whether or not a branch as per Section 24 (3) of the Act on Branches of Foreign-Registered Companies has legal capacity. The various courts adopted various decisions on the issue. Pursuant to the Supreme Court's resolution, a branch acts on behalf

of its founder, has no legal capacity and may only represent its founder in a lawsuit. Here, we should note that this problem concerns and adversely affects not only branches of banks, but also branches of insurance companies, payment service providers and investment firms.

Together with the Association of Hungarian Insurance Companies and the National Association of Securities Dealers, we initiated with the Ministry for National Economy an amendment to the legislation. However, the amendment, incorporated in draft law No. T/8099 on Amendments to Certain Financial Laws was inadequate. We indicated this fact several times to the Ministry for National Economy, but with no result. The amendment raises new concerns. Namely, it allows the branch to decide on a case-by-case basis whether to act in is own name or on behalf of its founder. This is unacceptable from prudential and well as from consumer protection points of view. The legislation was passed by Parliament on October 8. Through an amendment proposal submitted before the final vote, a provision adversely affecting the legal status of foreign branches was included in the Act. Pursuant to this, a foreign branch has legal capacity and may acquire rights and assume obligations on behalf of the foreign company. In particular, it may acquire assets, conclude contracts and sue and be sued. The text of the legislation contains an unsolvable contradiction, since under EU law, legal capacity means that the person/entity in question acquires rights and assumes obligations in its own name and on its own account.

Unfortunately, the Act cannot be interpreted in itself, because it contains serious contradictions and also conflicts with other legal regulations on branches of foreign companies and financial branches. We hope that the legislators will find a way to correct this obvious legislative error as soon as possible.

3.3. Supreme Court working document on unilateral contract amendments

In accordance with the relevant provisions of the Act on Courts, the Supreme Court has set up an analysis group to examine the case law of courts in judging whether the provisions on the unilateral amendment of contracts, as stipulated in financial institutions' general terms and conditions for consumer loans, were unfair. The analysis group is charged with examining the case law of courts, the topics to be examined are determined by the Supreme Court on an annual basis. Members of the analysis group include judges from the Supreme Court and Courts of Appeal. A researcher and an economist are also involved in the group's work. The analysis group completed a working document and sent it for review to the Association and 18 other professional organisations and NGOs, including the MNB, the Chief Prosecutor, the Hungarian Financial Supervisory Authority, the Hungarian Bar Association and consumer organisations. Comments were invited by October 15. The comments received will also be discussed at a conference. The final document is expected to be submitted to the Supreme Court's Civil Law College in December. Based on this, the Civil Law College may issue an opinion, which may be decisive for the case law of Hungarian courts in this matter and may affect the judgement of thousands of loan contracts concluded before the financial crisis.

The working document addresses the unilateral amendment of contracts for consumer loans other than home loans, that is, for home equity loans and long-term consumer loans. Contracts may be unilaterally amended to the detriment of the consumer in respect of interest, charges and fees.

We reviewed the working document with a small legal expert group. Our position, submitted on October 15, was co-signed by the National Association of Savings Cooperatives, the National Interest Representation Organisation of Savings Cooperatives, the National Association of Financial Firms and the Association of Hungarian Mortgage Banks. While certain conclusions of the Supreme Court's working document are undoubtedly right, some others need to be complemented and, in our opinion, corrected. The working document fails to analyse in sufficient depth the provisions on the unilateral amendment of contracts in the Banking Act (as modified several times) and the relevant banking practice and case law of courts.

In our comments we pointed out that the Civil Code's provisions on unfair commercial practice (Article 209) cannot be applied in case a general term of contract violates a coercive law, because pursuant to Article 200 of the Civil Code, the term in question is by definition null and void.

Also, unfairness cannot be examined in case the contractual term in question is provided by statute, or reflects a statutory provision. In our view, the examination of unfairness can be relevant if the general contract term materially deviates from a permissive law.

In relation to the Code of Conduct on retail banking services we explained that although the Code was not a legal statute, the Hungarian Financial Supervisory Authority could call banks to account for its violation. We pointed out that the Code's provisions have been approved by the Supervisory Authority, hence, the signatories have all reasons to believe that these provisions do not violate any law. We drew attention that if a provision in the general contract terms is based on a former provision of the Banking Act which at that time was mandatory, then that flawed provision cannot serve as a basis for examining the unfairness of a contractual term under the Civil Code. Namely, this would lead to courts checking the compliance of previous laws with current professional ethical norms, which would mean that economic actors could be held to account for a provision that not only was mandatory at the time of concluding the contract but in some cases did not even arise in view of the then applicable regulations.

3.4. Proposed amendments to the Anti-Money Laundering Act

The proposed amendments to the Anti-Money Laundering Act are planned to be enacted effective 2013. No major changes in the legislation are expected, a new law is expected to be enacted after the 4th Anti-Money Laundering Directive is adopted. Although the Ministry for National Economy accepted our request to allow banks to copy customers' ID documents for customer identification and due diligence purposes, the National Data Protection Authority continues to oppose it, or more precisely: would only accept copying without the photo.

Another problem is that with the introduction of the intraday settlements system (IG2), the transactions must be executed within four hours, which significantly reduces the time available to carry out the necessary checks. The Tax Authority's unit receiving the AML reports does not have the ability to decide on the suspension of the transaction in such a short time. Banks need guidance as to how to enforce the non-disclosure rules and further guarantees are needed to protect reporting employees.

3.5. Proposed amendments to the Credit Bureau Act

During the implementation of the legislation on Central Credit Bureau (CCB), a number of issues arose which could not be settled by common interpretation or authority rulings. To solve these issues, the Association initiated with the Ministry for National Economy amendments to the legislation.

In our relevant letter, we provided text proposals, pointing out and explaining the need to

- update the information on loan repayments on a monthly basis,
- ensure that private customers can receive official information about the data to be reported to the Central Credit Bureau on the spot, right upon conclusion of the loan agreement (and not subsequently through expensive correspondence),
- cancel the provision requiring the provision of the information mentioned in the previous point to corporate customers (the data protection requirements do not apply to the corporate sector)
- increase the timeframe for entering the information in the CCB from two days to five days (to improve data reliability),
- allow ex-post inquiries from the CCB for monitoring purposes (this is an existing requirement for banks under another law) ill.
- to allow the organisation managing the CCB to introduce a benchmark ratio to assist users of the CCB in assessing the customer's creditworthiness.

The first four items were adopted by Parliament and the Ministry for National Economy promised to support the inclusion of the remaining two items in the legislation.

4. Communications

The Association continued to conduct active communications in the third quarter. The launch of the intraday settlements system (IG2) and regular publication of the results of the Exchange Rate Cap Scheme II were the main focus issues. We presented the technical details of the IG2 system to journalists at our traditional Press Club event and gave regular updates on the smooth operation of the system.

In response to the government's announcement on a financial transaction levy, we issued two prompt press statements at the end of June and continued to communicate and emphasise the economic risks of this levy. The keen interest shown by the media in the wake of our communications of the concerns and risks added significant weight to the proposals submitted by our negotiating team. For example, the levy was capped at HUF 6,000 per transaction and this cap has remained even after the unexpected government announcement in the autumn.

The experience shows that the media now regards the Association and its representatives as real opinion-makers. This new communications relationship helps in getting our messages to the public and reducing the approaches made to members' Communications Departments, for example, to comment on the various legislative proposals.

5. International Developments - European Banking Federation[1]

The creation of a Banking Union and a Single Supervisory Mechanism (SSM), announced on June 6, was a key issue addressed by the European Banking Association in the third quarter. The EBF has long supported and welcomes the reform and harmonisation of banking supervision in Europe. At the same time, the EBF emphasises that the development of a Single Rulebook to be consistently applied in all 27 member states is prerequisite for an efficient SSM. The EBF supports the proposal for the ECB to supervise euro-zone banks, however, for efficiency, day-to-day supervision should conducted by national supervisors based on a single supervisory approach. The EBF emphasises that the role of the EBA should not be weakened by the SSM: it should remain the same, to enforce the Single Rulebook and to ensure convergent supervisory practices throughout the EU.

Another key issue is the Liikanen High-Level Expert Group's report on possible reforms to the structure of the EU banking sector. Already before publication of the report, the EBF had expressed its opinion that first, the ongoing regulatory reforms should be implemented and the need for any additional structural measures should only be considered afterwards. In its comments, the EBF defended the universal banking model and expressed its opposition to the separation of certain banking activities. In the EBF's view, the Liikanen proposal is detrimental to efficient functioning of the single market and restricts competition.

In relation to the trilogue[2] on CRD4/CRR, the EBF gives special emphasis to systemic risk buffers, the liquidity ratios and the weighting of SME exposures (with a view to ensuring that the preferential weights are applied not only to retail exposures but also to SME exposures in the corporate portfolio). The European Parliament is expected to decide on the adoption of CRD4/CRR at its plenary session of November 21. Should the decision be delayed, the postponement of implementation or the provision of a transitional period would become inevitable.

The EBF, consistent with its view of any structural reform being untimely, supports the proposal for the development and early implementation of a bank recovery and resolution framework. Although the relevant draft directive provides for a minimum harmonisation, the EBF advocates for the highest possible degree of harmonisation that leaves no room for national opt-outs and alternative options on the key elements of the Directive. The EBF supports the creation of a framework that minimises the systemic and fiscal consequences of bank failures and eliminates moral hazard. The EBF stresses that the resolution frameworks should be introduced globally to ensure a level playing field. It also draw attention to the need for the legislation to provide for the accountability and liability of the institutions and authorities involved in crisis management. (A decision on the directive is expected at the beginning of 2013).

[1] Details on the developments in global and European prudential regulation are presented in the Annex.

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

Other key issues addressed by the EBF include the proposed revision to MiFID, the proposed FTT, the obligations ensuing from the FATCA and the package on bank accounting. Priorities also include the trilogue on mortgage lending, issues related to payments, the proposed revision to the Payments Directive, the Green Paper on card, internet and mobile payments, the investigation on e-payments, the AML Directive, the regulation on central depositories and the regulation on Package Retail Investment Products (PRIPs).

6. Other developments affecting the banking sector

6.1. IG2 – Intraday Settlements System

The intraday settlements system went live on July 2, 2012.

As opposed to the T+1-day execution time in the previous system, electronic payment instructions in the new system are executed on the same day. Thus, the customer receives the money one day earlier. The new system has a long-term significance. In the inter-bank space, credit transfers are executed according to the SEPA standards. The SEPA payment schemes are becoming increasingly common in the EU and will be mandatory in the eurozone from 2014. From the banks' point of view, this means that when the euro is introduced in Hungary, only the currency type will have to be changed.

By connecting their internal systems to the banks' systems according to the SEPA standards, companies can make payments automatically, without any manual intervention. Here, again, transition to the euro will only require minor adjustments to the systems.

The system is running smoothly. In the first two months, approx. 24 million transactions were executed to a total value of HUF 9,000 billion, without any failure. The system was implemented under a national project. Participants in the project included the MNB, GIRO, the Association and the banks. With the successful launch of the system, the project was dissolved.

6.2. Preparations for the FATCA

Pursuant to the US Foreign Account Tax Compliance Act, Hungarian financial service providers are required to enter into bilateral agreements with the IRS for meeting their obligations under the FATCA.

In September, we held a meeting on FATCA compliance with the Tax Policy and International Taxation Department of the Ministry for National Economy. The Ministry said it was actively addressing the issue: it had attended the relevant USA-EU consultation and follows closely the developments in the ECOFIN as well.

According to the Ministry, the model agreement related to the FATCA need to be adapted to Hungary. We explained that due to EU and international legal constraints banks cannot individually enter into agreements with the IRS. We pointed out that an inter-governmental agreement would involve information exchange, which would be an asset for Hungary, by receiving information on Hungarian-source funds used or parked in the USA. Since there is tax cooperation between the USA and Hungary, an agreement based on information exchange appears to be feasible.

An inter-governmental agreement would also be preferable because the provisions of the model agreement are more favourable than those contained in the FATCA guidelines and in the implementation rules now under public consultation. The Ministry requested the banking side's assistance. The parties agreed to work closely together on the issue.

6.3. Data Protection Sub-Working Group established

In July 2012, a Data Protection Sub-Working Group was established under the Association's Legal Working Group. The Sub-Working Group is charged with following Hungarian and EU data protection regulations, drafting proposals and developing best practices mindful of the relevant provisions of the Competition Act. The Sub-Working Group is a consultation forum for banks' data protection officers, legal counsels interested in data protection, compliance officers and IT officers. Members elected Dr József Baki of FHB as head of the Sub-Working Group. At its meeting in September, the Sub-Working Group addressed issues related to the data protection of agent registers, the need for amendments to the Info Act and the possibilities for developing common data protection procedures for the sector.

6.4. Association publications

On the 25th anniversary of the reinstatement of the two-tier banking system in Hungary, the Association issued two publications. One is a collection of essays, written by bank analysts, economists and associates of the Association on the sector's role and challenges.

The second publication is a banking glossary, compiled by some 20 specialists. The glossary provides the reader with a comprehensive collection of banking terms and definitions.

In the wake of the invitation for essays published in February, a special edition of our *Hitelintézeti Szemle* was published in August, with articles written by doctoral students. The special edition and the new editions of *Hitelintézeti Szemle* carry the Association's new corporate identity elements.

ANNEX - International developments: regulation, supervision, EBF

ANNEX

INTERNATIONAL DEVELOPMENTS:
REGULATION, SUPERVISION - EUROPEAN BANKING FEDERATION

I. GLOBAL REGULATION

I.1 RISK DISCLOSURE AND REPORTING REQUIREMENTS

1.) The Financial Stability Board's Enhanced Disclosure Task Force (EDTF) published its proposed disclosure principles. The proposal, revised based on comments received, was resubmitted for a two-week public consultation in October, following which it will be submitted to the FSB for approval. The EDTF is tasked to

(i) develop principles for enhanced disclosures,

(ii) make proposals to improve current risk disclosures, including ways to enhance the comparability of the reports, and

(iii) identify leading practice risk disclosures for global financial institutions.

According the proposed principles, disclosures should

1. be clear, balanced and comprehensible,
2. be comprehensive and covering all operations and risks of the bank,
3. relevant,
4. present and reflect the bank's risk management practices.
5. time-consistent (allowing comparisons between the various periods).
6. comparable between banks,
7. disclosed in time (not delayed).

The EDTF draft document provides detailed explanations for the proposed principles and contains further proposals to improve risk disclosures, risk strategies and risk management/business models as well as proposals related to capital, RWA, liquidity, funding, and credit, market and other risks.

The FSB expects international banking associations to support the proposed disclosure principles. (The EBF will discuss the proposal at its Executive Committee Meeting of October 25). Some of the principles will have to be applied to the end-2012 risk disclosures.

2.) During the summer, the Basel Committee for Banking Supervision (BCBS) published a consultation document on principles for effective risk data aggregation and risk reporting. The document responds to the lesson learnt from the financial crisis that banks - and primarily global systemically important banks (G-SIBs) - lacked the ability to aggregate risk exposures quickly and comprehensively. The principles proposed by the Committee are aimed to enhance banks' risk data aggregation capabilities and risk reporting practices, and thus, banks' risk management and response to stress. G-SIBs should meet the proposed principles by the beginning of 2016. The Committee considers that national supervisors may also choose to apply the proposed principles to a wider range of banks, in a way that is proportionate to the size, nature and complexity of these banks' operations.

In their joint response to the proposal, global trade associations supported the objectives set by the BCBS. At the same time, they drew attention to the IT investment needs entailed by the increased data collection and reporting requirements. They pointed out that while the beginning-2016 deadline for implementation of the principles themselves could be workable, in view of the related regulatory requirements, more time was needed for implementation.

I.2 Capital and margin requirements for clearing transactions

1.) Following two rounds of consultation, in July the Basel Committee published interim rules for the capitalisation of bank exposures to Central Counterparties, to take effect on January 1, 2013, as part of the Basel III framework. The proposed framework builds on the new CPSS[3]-IOSCO[4] Principles for Financial Market Infrastructures. Where a CCP is supervised in a manner consistent with these principles, exposures to such CCPs will receive a preferential capital treatment. In particular, trade exposures will receive a nominal risk-weight of 2%. In determining the capital required for exposures to default funds, banks may choose between a risk sensitive approach, or a simplified method with a 1250% risk weight. With this preferential treatment the BCBS seeks to promote the use of central counterparties.

2.) In 2011, the G20 leaders agreed to add margin requirements for non-centrally-cleared derivatives to the reform programme for over-the-counter (OTC) derivatives markets. Accordingly, the BCBS and IOSCO launched a public consultation on margin requirements for non-centrally-

[3] Committee on Payment and Settlement Systems

[4] International Organization of Securities Commissions

cleared derivatives. Margin requirements can further mitigate systemic risk in the derivatives markets. In addition, they can encourage standardisation and promote central clearing. The requirements will apply to all financial firms and systemically-important non-financial entities. The BCBS emphasises that to prevent regulatory arbitrage, global and consistent implementation of the margin requirements is crucial. At the same time, it is also important to consider the potential impact of margin requirements on financial markets and the broader financial system. The potential benefits should be weighed against the liquidity impact arising from the need for derivative counterparties to provide liquid, high-quality collateral when meeting margin requirements. Therefore, the Basel Committee and IOSCO plan to conduct a quantitative impact study (QIS) during the consultation period. The consultation runs until October 28.

I.3 Basel Committee consultative document on managing risks associated with the settlement of foreign exchange transactions

This document, published in August, updates the Committee's supervisory guidance on managing risks associated with the settlement of foreign exchange transactions, issued in 2000. The Committee points out that although in the past 10 years the foreign exchange market has made significant steps in reducing the risks associated with the settlement of FX transactions, substantial FX settlement-related risks remain, not least because of the rapid growth in FX trading. The proposed new guidance provides more comprehensive and detailed direction on the management of risks (principal risk, replacement cost risk, liquidity risk, operational risk, legal risk) and capital requirements for FX transactions. The main proposals are as follows:

- A bank should ensure that all FX settlement-related risks are effectively managed and its practices are consistent with those used for managing other counterparty exposures of similar size and duration.
- A bank should reduce its principal risk as much as practicable by settling FX transactions through the use of financial market infrastructures that provide payment-versus-payment (PVP) arrangements. Where PVP settlement is not practicable, a bank should properly identify, measure, control and reduce the size and duration of its remaining principal risk.
- A bank should ensure that when analysing capital needs, all FX settlement-related risks should be considered, including principal risk and replacement cost risk and that sufficient capital is held against these potential exposures.

I.4 Basel III regulatory consistency assessments (Preliminary reports: Europe, USA, Japan)

In accordance with its promise[5], at the beginning of October, the Basel Committee published its preliminary assessments on the consistency of the new regulations adopted in the various jurisdictions with the Basel III framework. These Level 2 assessments reviewed implementation in Europe, the USA and Japan.

In Europe, the definition of capital and the application of permanent partial exemptions were graded as non-compliant. In the USA, the securitisation framework was judged as non-compliant. In Japan, although rules for capital buffers (conservation and counter-cyclical) are still under discussion, the framework does not deviate from the Basel III framework.

II. European Union

II.1 Banking union

On September 12, 2012, the European Commission published a comprehensive proposal package for the creation of a banking union. The package includes:

- a regulation conferring powers to the European Central Bank concerning the prudential supervision of credit institutions,
- an amendment to the current regulation on the European Banking Authority;
- a communication on the roadmap for a banking union, covering the single rulebook, common deposit protection and a single bank resolution mechanism.

The European Central Bank will become responsible for the prudential supervision of credit institutions established in the euro zone member states (participating member states). Member states outside the euro zone can also choose to join the Single Supervisory Mechanism (SSM).

The ECB will, be the competent authority, inter alia, for authorising credit institutions, assessing qualifying holdings, ensuring compliance with the minimum capital requirements, ensuring the adequacy of internal capital in relation to the risk profile of a credit institution (Pillar 2 measures), and conducting supervision on a consolidated basis and supervisory tasks in relation to financial conglomerates. Furthermore, the ECB will also ensure compliance with provisions on leverage and liquidity, apply capital buffers and carry out, in coordination with resolution authorities, early intervention measures when a bank is in breach of, or is about to breach, regulatory capital requirements.

[5] See point I.1 of the Annex to our Q2 2012 report

National supervisors will remain in charge of consumer protection and the fight against money laundering, and of the supervision of third country credit institutions establishing branches or providing cross-border services within a member state. Most day-to-day verifications and other supervisory activities necessary to prepare and implement the ECB's acts will be exercised by national supervisors.

To allow for a smooth transition to the new mechanism, a phasing-in period is envisaged. As a first step, as of January 1, 2013, the ECB will be able to decide to assume full supervisory responsibility over any credit institution, particularly those which have received or requested public funding. As of July 1, 2013 all banks of major systemic importance will be put under the supervision of the ECB. The phasing-in period should be completed by January 1, 2014 when the SSM will cover all banks of the participating member states.

In its relevant press release, the European Banking Federation welcomed the proposal to give the European Central Bank the mandate to supervise all banks in the euro area, as part of a new single supervisory mechanism. At the same time, it drew attention that further, equally ambitious steps will be required to create a common resolution mechanism and a harmonised deposit guarantee frame.

II.2 Rapporteur's draft report on the Green Paper on shadow banking

While recognising the need for global regulation, the EU rapporteur provides a number of recommendations for the European Commission to submit regulatory proposals by the beginning of 2013. The rapporteur recommends the following:

- Imposing capital requirements for liquidity lines for SIVs (structured investment vehicles and conduits) and extending the large exposure limit of 25% of own funds to all unregulated entities. Also, the extension of CRD IV requirements to non-banking entities should be seriously considered.
- To make bank balance sheets more reliable, entities which are not consolidated from an accounting perspective should be consolidated for prudential consolidation purposes.
- The European Commission should submit a legislative proposal for the separation of retail and investment banking activities.
- Regulators should be allowed to impose minimum haircuts or margin levels for the collateralised financing markets (repo, securities lending).
- The European Commission should submit a legislative proposal to put a cap on the number of times a financial product can be securitised. Steps should be taken in the direction of more standardisation of securitisation products and imposing stricter retention requirements.
- The European Commission should submit a legislative proposal requiring Money Market Funds either to adopt a variable asset value with a daily valuation or, if retaining a constant value, to be subject to capital requirements .
- The European Commission should submit a legislative proposal to tackle the structural vulnerabilities of Exchange Traded Funds.

In addition to these regulatory proposals, the rapporteur stressed the need to collect more and a better data on shadow banking transactions.

Responding to the draft report, the EBF reiterated that EU and national regulations should be preceded by a global regulation. The EBF proposes the use of the term "parallel banking" instead of shadow banking, as this would better express the nature of these activities. The EBF considers the regulatory proposals as premature and disagrees with most of them. There have been several regulations adopted in the areas affected, therefore, first, the impacts of these regulations should be monitored and assessed before developing any new regulations. The EBF raises that the report should address insurance and reinsurance companies and all those other institutions that provide services similar to those provided by banks.

II.3 Amendments to the EU regulation on Credit Rating Agencies (Regulation 1060/2009/EC)

The trilogue between the European Commission, Parliament and Council continues.[6] There is no agreement yet on the mandatory rotation and the civil law liability of CRAs, the rules for rotation have not yet been discussed at all. Some progress was made on the issue of overreliance on external ratings: where possible, the references to external ratings will be removed.
It seems that the European Parliament will not be able to vote on the proposed amendments on the set date (October 22). However, the parties hope that a final agreement can be reached still during the Cypriot presidency.

II.4 Report of the High-Level Expert Group on reforming the structure of the EU banking sector (Liikanen report)

The final report from the Liikanen High-Level Expert Group (HLEG) recommends further regulatory initiatives in 5 areas:

1. Mandatory separation of proprietary trading activities and other significant trading activities over a certain threshold. The decision on separation should be made taken in two stages:

- In the first stage, if a bank's assets held for trading and available for sale exceed a relative examination threshold of 15-25% of the bank's total assets, or an absolute examination threshold of EUR100 billion, it will advance to the second stage examination.
- In the second stage, supervisors would determine the need for separation based on the share of assets to which the separation requirement would apply. This threshold, as share of a bank's total assets, is to be calibrated by the Commission.

[6] For more on the European Commission's November 2011 proposal see our Q4 2011 report.

2. Additional separation of activities conditional on the Recovery and Resolution Plan (RRP).

3. Designated bail-in instruments**:** banks should build up a sufficiently large layer of bail-inable debt that should be clearly defined, and such debt instruments should be held outside the banking sector, to prevent contagion.

4. A review of capital requirements on trading assets and real estate related loans:

- Setting a non-risk weighted capital buffer requirement on top of Basel 2.5 + 3 requirements for banks with trading activities over a certain threshold and/or introduction of a floor for risk-based requirements (i.e. (RWA).
- Inclusion of loan-to-value (LTV) and/or loan-to-income (LTI) caps in the macro-prudential toolbox.

5. Better corporate governance:

- Strengthening management and boards, especially for large and complex banks, better use of fit-and-proper tests.
- Promoting the risk management function, especially more detail in the level 2 rules.
- Creating better incentive schemes: a share of the variable pay must be in the form of bail-in bonds. Imposing further restrictions on the ratio of variable income to fixed income and an absolute cap on overall compensation.
- Improving risk disclosure for banks.
- Strengthening supervisors' sanctioning powers.

Upon the publication of the Liikanen recommendations, the EBF issued a press release, stressing that the recommendations might weaken banks' ability to fund the real economy. The EBF calls on the European Commission to carefully assess the recommendations and their impact on the economy. It also drew attention to the need for a proper consultation period and impact assessment and for taking into account the ongoing European regulatory reforms.

In relation to the ring-fencing of trading activities, the EBF also challenges the proposal to give up the universal banking model and expresses concerns over an unlevel playing field.

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

III.1 EBA second report of the Basel III monitoring exercise

At the end of September, the EBA published its second report on the results of the Basel III monitoring exercise, based on consolidated data as of December 31, 2011, including a comparison with the results of the previous exercise, conducted based on data as of June 2011 and published in April 2012. The report is based on consolidated data of 156 European banks. 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.

For the purpose of the exercise banks were classified in Group 1 (44 banks from 14 countries) and Group 2 (112 banks from 17 countries), Group 1 banks being those with Tier 1 capital in excess of EUR 3 billion and internationally active. Group 1 covered almost all EU banks in this category (92%), the coverage for Group 2 banks was lower (27%).

Assuming full implementation of the Basel III framework as of December 31, 2011 (without taking into account transitional arrangements), the CET1 capital ratios of Group 1 banks would have declined from an average CET1 ratio of 10.3% to an average CET1 ratio of 6.9%. 88% of Group 1 banks would be at or above the 4.5% minimum while 49% would be at or above the 7% target level (including the capital conservation buffer). The CET1 capital shortfall for Group 1 banks is EUR 8 billion at a minimum requirement of 4.5% and EUR 199 billion at a target level of 7%. Taking into account the capital conservation buffer and the surcharge for global systemically important banks, Group 1 banks' capital shortfall rises to more than EUR 400 billion. For Group 2 banks, the average CET1 ratio declines from 10.6% to 7.2% under Basel III, where 92% of the banks would be at or above the 4.5% minimum and 76% would be at or above the 7% target level. The respective CET1 shortfall is approx. EUR 10 billion at a minimum requirement of 4.5% and EUR 26 billion at a target level of 7%.

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 20.5%, RWAs increase by 18.4% on average. For Group 2 banks, while the change in the definition of capital results in a decline in CET1 of 26.1%, the new rules on RWA affect Group 2 banks far less (+8.8%). The decrease in Group 1 and Group 2 banks' CET1 is mainly driven by goodwill and deductions for holdings of capital of other financial companies. Group 1 banks' RWA increase is mainly driven by CVA capital charges.

Group 1 banks show an average Basel III Tier 1 leverage ratio (LR) of 2.9%, while Group 2 banks' leverage ratio is 3.3%. 51% of Group 1 banks and 70% of Group 2 banks would meet the 3% target level as of December 2011. Compared to the previous period, monitoring results show almost no change in average leverage ratios (+0.2 percentage points for Group 1 while for Group 2 banks it remains nearly unchanged).

Liquidity standards are currently subject to an observation period which includes a review clause to address any unintended consequences prior to their respective implementation dates of January 1, 2015 for the LCR and January 1, 2018. Group 1 banks have reported an average LCR of 72% while the average LCR for Group 2 banks is 91%. The aggregate Group 1 and Group 2 shortfall is at EUR 1.17 trillion, which represents 3.7% of the EUR 31 trillion total assets of the total sample. Group 1 banks reported an average NSFR of 93% (Group 2 banks: 94%). To fulfil the minimum standard of 100% on a total basis, they need additional stable

funding of EUR 1.4 trillion. Compared to the previous period, the monitoring results show improved liquidity ratios for both Group 1 and Group 2 banks.

The Basel Committee for Banking Supervision also completed a second Basel III monitoring exercise, for the same period and under the same assumptions[7]. The global review included 102 Group 1 banks and 107 Group 2 banks. (Members' coverage of their banking sector was high for Group 1 banks, reaching 100 percent for some jurisdictions, while coverage for Group 2 banks was comparatively lower for and varied across jurisdictions). The results of the exercise show no significant difference from the European exercise. However, the global data for capital adequacy, leverage ratio and liquidity ratios were better than those for Europe.

III.2 EBA WORKSHOP ON REGULATORY REPORTING STANDARDS

On September 13, the EBA held a workshop on regulatory reports. The EBA's officials presented the changes made upon the comments received in the proposed Implementation Technical Standards (CP50, CP51) and the related data point models (DPM) and the relationship between the various data (hierarchies, formulas). The data templates may of course change depending on the final texts of CRD4 and the CRR. The Implementation Technical Standards (ITS) will be introduced concurrently with the new capital framework (at this point January 1, 2013). At the same time, the delay in adopting the new capital framework[8] is a major challenges for institutions. Therefore, concurrently with the announcement of the workshop, the EBA mooted the gradual introduction of certain reporting requirements (which also signals the postponement of the introduction FINREP-related reports to January 1, 2014).

Participants in the workshop inquired about the implementation dates of the proposed ITS. The EBA was not able to give a final answer. However, it promised that after adoption of the CRR, it will

- align the ITS with the final text of the CRR, including the relevant legal references,
- set an implementation date for the ITS consistent with the CRR,
- gradually introduce certain reports (subject to the time period between the adoption and implementation of the CRR).

The EBA's officials believe that the related ITS can be issued within six weeks after adoption of the CRR. The EBF's representatives attending the workshop expressed a number of concerns (such as the reality of the proposed timeline, the introduction of FINREP, reports that cannot be generated from the accounting systems, the influence of national supervisors, etc.). Liquidity reporting was not addressed at the workshop.

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[7] Basel Committee on Banking Supervision: Results of the Basel III monitoring exercise as of 31 December, 2011 September 2012

[8] The CRD4/CRR had been expected to be adopted during the Danish presidency in June 2012.

III.3 Regulatory and Implementation Technical Standards and guidelines

In the third quarter, the EBA conducted consultations and issued regulatory standards and guidelines as follows:

- Consultation on Draft Regulatory Technical Standards (RTS) for credit valuation adjustment(CVA) risk. (CP/2012/09)
- Consultation on Draft Regulatory Technical Standards (RTS) on the calculation of credit risk adjustments (CRA). (CP/2012/10)
- Joint consultation of the European Supervisory Authorities on the capital calculation methods for financial conglomerates. (JC/CP/2012/02)
- Draft Regulatory Technical Standards for capital requirements for CCPs.
- Guidelines on remuneration benchmarking (GL/2012/4, GL/2012/5).

IV. European Banking Federation - EBIC[9] - IBFed[10]

IV.1 EBF response to the CSBS consultation on the fundamental review of the trading book.

The EBF's considers this review as an integral part of the regulatory reform on trading book. The EBF points out that the reform should be carefully designed to preserve the merits of the background systems and infrastructure, while overcoming the problems that have become apparent during the crisis. The EBF welcomes the Committee's objective to seek a more consistent framework for trading book risk. On the other hand, it stresses that the cost of implementation and operation of the new models proposed also need to be taken into account.

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

[10] 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)

The EBF recommends that the new framework should be based on the following pillars:

- The use of a trading-evidence boundary (rather than a valuation-based boundary). Alignment between the models used for capital and those used for risk management.
- The availability of a simple standardised approach. (Given that the standardised approach is a fallback solution for banks which may not receive approval for internal models, while internal models are the only option for smaller banks, banks should be allowed to opt for either of the two approaches depending on their needs and capacities).
- The use of the standardised calculations for large banks only as a benchmark (and not as a floor) on a half-yearly basis.

The EBF emphasises that it would be essential to conduct a quantitative impact study (QIS) before determining the final rules. However, given that the Basel Committee's proposal remains at a high-level, the EBF suggests launching a second consultation on specific rules (using scenarios, if necessary) before carrying out the QIS.

The IBFed, in conjunction with other international trade associations, provided a joint response to the proposal. While the EBF gives special emphasis to the option to choose between the standardised approaches, the joint industry response argues for a coherent and comprehensive risk-based framework.

IV.2 EBF COMMENTS ON THE PROPOSED DIRECTIVE ON A RECOVERY AND RESOLUTION FRAMEWORK

In relation to the proposed Directive, the EBF has pointed out the following top ten issues:

1. The Resolution Colleges should be limited in number of Resolution Authorities in order to be more effective, but have a mandate for global financial stability with the home authority as the lead authority;

2. Recovery Plans should be undertaken at a group level unless management believes plans should also be prepared for subsidiaries and this is agreed by the competent authorities. The possibility of preparing individual RRPs on a voluntary basis must be ensured.

3. The confidentiality of Recovery and Resolution Plans should be strengthened, oversight established and sanctions imposed in the case of a breach of confidentiality requirements.

4. Recovery and Resolution Plans or other preventive measures should not be used for supervisory intervention in the structure or operation of healthy financial institutions without restructuring or resolution having become necessary.

5. Early intervention measures must be clearly defined in terms of their respective tools and measures. These in turn must be used proportionally where some measures are more appropriate for resolution purposes.

6. Given the signalling risks in the public disclosure of the use of early intervention tools, the recovery phase must remain private and the management in place should have the choice of recovery tools applied. Boards of Directors must retain sole control of the institution to ensure that they are able to fulfil their fiduciary duties under corporate law.
7. The degree of supervisory discretion implied by the conditions necessitates resolution authorities to work with the institutions and the market to explain how the resolution tools may be implemented in practice

8. Members generally support bail-in as a resolution tool, but stress that it must be a last measure (*ultima ratio*). Concern remains among some members to use bail-in as a recovery tool as the aim of the bail-in tool is to protect taxpayers in a resolution situation.

9. There should be no requirement for firms to hold a specific proportion of their Total Liabilities as bail-in instruments. An alternative would be for Resolution Authorities to ensure that each institution maintains a sufficient amount of bail-inable liabilities as an extension of the Recovery and Resolution Planning process. There should not be a one-size-fits-all minimum.

10. As for the Directive on DGS, the proposal by the Commission has been amended by the Council and the European Parliament, but there is no agreement yet. It is important to ensure the consistency of both Directives in this regard, while taking into account the differences in scope where relevant:

    - In line with the current DGS discussions in Council and Parliament the fund should be built up over 15 years rather than 10.

    - The EBF deems the annual contribution at the level of 0.25% of covered deposits to be much too high. A lower level should be set.

    - Borrowing between financing arrangements should be based on voluntary agreements between member states.

    - Any contribution to resolution by the DGS must always be capped to the net amount of the losses it would otherwise have incurred in a payout to depositors, based on the "no creditor worse off" principle. DGSs should not be subject to a double cost in the event the institution is unsuccessfully resolved, leading to insolvency and triggering a payout.

IV.3 EBF response to the Basel Committee's proposal for a framework for dealing with domestic systemically important banks (D-SIBs)

Under the Basel Committee's consultation on D-SIBS, the EBF pointed out that the proposed D-SIB framework should not replace or take priority over the necessary improvements in supervision and resolution tools. The methodology proposed to identify and address D-SIBs should be subject to an informed and structured impact assessment. The EBF recommends that the extension of the SIB framework to domestic institutions should be designed with respect for the following principles:

- The proposed measures should be put in the context of a wider range of policy tools for systemic risk prevention, in which SIB buffers are just a complementary measure that does not entirely tackle the causes of systemic risk.
- The capital buffers should be kept under a limited level.
- Complexity, wrong incentives and divergences that could only give rise to uneven playing field situations should be avoided.

Since the EU is already foreseeing ambitious additional measures for SIFIs, it would not be acceptable that both regimes, the global and the European, are additive and expressed in different terms. Consistency with the global prudential framework is essential for a coherent systemic risk framework. The harmonisation of the regulatory environment and supranational institutional supervisory framework in the EU (i.e. the European System of Financial Supervisors) should be taken into account in the rules governing the systemic risk framework.
The EBF gave detailed comments, inter alia, on the degree of national discretion, cross-jurisdictional consistency, non-banking entities, the role of supervisory colleges, incentives to resolvability, the interplay between the G-SIB and D-SB frameworks, additional tier 1 capital, incentives to risk mitigation, disclosure requirements, the correlations with the banking union in Europe and the overall impact of the proposed framework.

The IBFed also provided comments on the proposed D-SIBs framework. These, in many instances, were similar to those made by the EBF.

IV.4 EBF RESPONSE TO THE EBA CONSULTATION ON DRAFT GUIDELINES ON THE ASSESSMENT OF SUITABILITY OF MEMBERS OF THE MANAGEMENT BODY AND KEY FUNCTION HOLDERS (CP/2012/03)

The EBF is concerned and questions the opportunity to extend the Guidelines to key function holders: this would be disproportionate and give rise to the potential risk – in the absence of a clear legal basis – that the application of the guidelines would be challenged by employees against their bank employers. The EBF is also concerned about the high requirements regarding experience and education, which may not sufficiently take into account other criteria such as the diversity of views and experiences. The EBF also voice concern about the supervisory assessment process proposed by the draft guidelines, which, in the EBF's opinion, might not reflect the reality. In the EBF’s opinion, the power to assess the suitability of key function holders should stay with the credit institution.

IV.5 EBF RESPONSE TO THE EBA CONSULTATION PAPER ON DRAFT IMPLEMENTING TECHNICAL STANDARDS ON DISCLOSURES FOR OWN FUNDS (CP/2012/04)

In its response to the proposed ITS, the EBF supports the objective of achieving enhanced transparency. It believes that the proposed templates should be brought in line with the expectations expressed by the users' community. The EBF points out that EU authorities should increase their efforts to convince international institutions to adopt an integrated approach to reporting requirements on a global level. The EBF is of the view that disclosures regarding significant subsidiaries should only be required in exceptional circumstances. The EBF also points out that the

Capital Requirements Regulation does not provide the EBA with a legal mandate to prepare technical standards to impose disclosures requiring an accounting/prudential reconciliation of the whole balance sheet or to impose templates to be used by institutions during the transition phase.

IV.6 EBF response to the EBA consultation on draft Implementing Technical Standards on supervisory reporting requirements for liquidity coverage and stable funding (CP/2012/05)

In its response to this consultation, the EBF provided the following comments:

- The EBF proposes January 1, 2014 as a realistic implementation date for the liquidity reporting requirements.
- Remittance at D+15 is not feasible, and is not desirable as it would be detrimental to data quality. The EBF would also recommend a phased liquidity reporting approach of allowing more time at the beginning, such as 60 days, then reduced to 45 days and finally 25 working days.
- Mindful of the principle of proportionality, it should be avoided that the new liquidity reporting requirements are extended to small legal entities.
- The EBF is surprised that the EBA draft ITS on liquidity reporting include a reference to COREP, taking into account that COREP refers to the asset side of the balance sheet only and only concerns risk data.

IV.7 IBFed response to the BCBS consultation on monitoring indicators for intraday ***liquidity management***

The IBFED welcomes the statement that the proposed indicators are for monitoring purposes only and do not represent the introduction of new standards around intraday liquidity management. This is somewhat contradicted by the provision that banks are expected to report the monitoring indicators to their supervisor on a monthly basis, in line with the proposed LCR reporting requirements. In the IBFed's opinion it would be helpful to allow banks to “digest” Basel III before any new additional requirements are imposed on them. The reporting requirements will be costly to implement, and the IBFed urges policy makers to avoid establishing a regime that is excessively burdensome. Given that the reports will be prepared and sent to supervisors on a monthly basis on past intraday (hour by hour) information on several different variables and at the legal entity (possibly branch) level , the IBFed questions

- the amount of the information required,
- the use supervisors will make of it,

- its relevance in terms of intraday liquidity monitoring.

The IBFed considers that intraday liquidity risk should be defined more clearly in the text.

IV.8 EBF COMMENTS ON LEVERAGE RATIO REPORTING

1. At the beginning of August, the EBF wrote a letter to members of the EU trilogue, requesting amendments to the CRD4/CRR in relation to the leverage ratio. To align leverage ratio reporting with COREP, the EBF proposed that the reporting frequency should be quarterly rather than monthly. It also proposed that leverage ratio reporting be only required at the consolidated level and not at the individual level, otherwise it would particularly hit those parts of a banking group that are engaged in traditional (retail) banking activities. Finally, in view of the delay in the legislative process of CRD4/CRR, the EBF proposed that the implementation date for the reporting requirements for the leverage ratio and all supervisory ITS is deferred until January 1, 2014.

2. In its response to the EBA consultation on supervisory reporting requirements for leverage ratio (CP/2012/06), the EBF also pointed out the need for a holistic review of all supervisory ITS, with a single data definition and the elimination of any duplicative templates. It also stressed that the remittance date for leverage ratio reporting should be set after the COREP remittance date and any information not required by CRD4/CRR should be removed. Also, it should be ensured that the observation period for the leverage ratio is used to assess and implement any identified refinements and corrections to the leverage ratio reporting requirements in continuous dialogue with the industry.

IV.9 EBF RESPONSE TO THE PROPOSED REVISION OF THE FINANCIAL CONGLOMERATES DIRECTIVE (FICOD)

The EBF supports the European Commission's efforts to identify the organisational structures that have remained outside the scope of the Financial Conglomerates Directive. Since the regulation of shadow banking may be relevant, it is important that these two issues are properly coordinated. Pursuant to the CRD, unregulated and unconsolidated members of bank groups are already subject to the FICOD.

IV.10 EBIC LETTER ON CRD4 IMPLEMENTATION

In August, the EBIC wrote a letter to the EU authorities, drawing attention to the practical difficulties caused by the delay in the legislative process of CRD4/CRR. The EBIC pointed out the need for a reasonable period of time between the adoption of CRD4/CRR and the implementation of the new rules. Firms will need to prepare staff, adapt systems and seek the necessary approvals from supervisors for the internal models that they may set up to meet the new counterparty risk and CVA requirements. These changes cannot be achieved within a timeframe of one or two months. Due to this, the EBIC doubts that the initial plan concerning the entry into force of the new legislative framework (i.e. January 1, 2013) remains realistic and achievable.