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HUNGARIAN BANKING ASSOCIATION

REPORT

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Executive Summary

The Hungarian banking sector operated in an adverse macro-economic environment both internationally and in Hungary. Contrary to expectations, economic growth slowed in the Eurozone and was close to stagnation, with the German economy showing very moderate growth, another negative development from Hungary's point of view. The stimulus measures implemented by the FED and the ECB failed to bring about a turnaround in the international environment.

GDP in Hungary dropped by 1.5%, the economy slipped into recession, with GDP falling in all three quarters of the year, as was the case in seven other EU countries (the Czech Republic, Greece, Cyprus, Italy, Netherlands, Slovenia and Spain). The lowest declines were recorded in Q3 in Hungary and Spain (1.5% each).

Total assets in the banking sector were at HUF 30,169 billion as of September 30, 2012, 90% of total assets in September 30, 2011. The net stock of loans fell by 16% (including corporate loans by 11% and retail loans by 18%), the stock of securities rose by 1% in the period between September 30, 2011 and September 30, 2012.

Banks' liabilities fell by HUF 3,169 billion in Q1-Q3 2012 year on year. Three-quarters of this decline was in foreign currency and a quarter in HUF. 54% of the decline came from interbank deposits, 35% from loans taken and 14% from debt securities. The stock of deposits fell by 1%, with corporate deposits dropping by 3%. The loans-to-deposits ratio declined by 27 percentage points to 131%. The role of deposits in the decline is negligible. Banks' capital adequacy ratio rose by 2 percentage points, to 14.71%.

After a HUF 243 million loss in 2011, profit after tax in the banking sector was also a negative HUF 10 million in Q1-Q3 2012. The difficult situation of the sector is reflected in its real ROE: -4.17 in 2010, -13.85 in 2011 and -5% in Q1-Q3 2012. The portfolio quality did not improve in Q4, either, with the NPL rate exceeding 20% in the corporate sector and being around 15%-16% in the retail sector.

There were two negative changes in the operating conditions of the sector: contrary to the agreement made with the Hungarian Banking Association in December 15, 2011, government announced that the bank tax would not be halved in 2013 and would remain fully in force as introduced in 2010. Another negative development was the amendment and finalisation in November of the new financial transaction levy taking effect in 2013, whereby the general levy rate was raised from 0.1% to 0.2% and that for cash transactions from 0.2% to 0.3%, both subject to a cap of HUF 6,000 per transaction. The government expects to collect HUF 140 billion from the bank tax and HUF 260 billion from the financial transaction levy in 2013.

In the retail sector, banks gave every assistance to customers seeking to join the Exchange Rate Cap Scheme. By the end of December, 100,000 eligible customers had signed up. Although this is not a bad result for an initial period, the Association welcomed the Government's proposal to extend the application deadline till the end of March.

In the context of corporate lending, it should be seen that a major part of the loan applications received from the SME sector cannot be accepted by banks for risk and return reasons.

A number of legislative decisions significantly affecting banks' present and future operations were adopted. Here, special mention should be made of the Supreme Court's working document on unilateral contract amendments and the expected consequences of this document, the regulations on branches of foreign banks and PSZÁF's recommendations on complaint handling and debt collection procedures.

In the fourth quarter, the European Union and the European Banking Federation continued to discuss the priorities addressed earlier during the year. The actions announced in June for the creation a Banking Union were not implemented, and the proposed Single Supervisory Mechanism (SSM) is only expected to be introduced in March 2014. After the publication of the Liikanen High Level Expert Group report on reforming the structure of the EU banking sector, the European Commission will make a proposal in the first half of 2013 for measures to be taken at the EU level. These will presumably include the mandatory separation of trading activities over a certain threshold. Despite earlier promises, the CRR/CRD4 trilogue[1] was not concluded under the Cypriot presidency. The trilogue continues in 2013. The European Parliament is expected to develop a position on the Bank Recovery and Resolution Directive in early 2013, the relevant trilogue will commence afterwards. Main developments in global regulation included the Financial Stability Board's report on financial regulatory reform, the Basel agreement on Liquidity Coverage Ratio and the re-regulation of the capital requirements for securitisation.

1. Economic environment

1.1. International environment, liquidity measures of the FED and the ECB, crisis management in the EU

The IMF forecasts global GDP to grow by 3.3% in 2012 and 3.6% in 2013. These growth rates basically correspond to the average growth rate of the past 30 years. The estimated 1.3-1.5% growth for the advanced economies is 1% lower, the 5.3-5.6% growth rate forecast for the developing economies is more than 0.5% higher than the thirty-year average growth. Out of the countries highlighted in the IMF's analysis, only Italy and Spain will remain in recession, while the UK., the euro-zone, the EU and Japan are expected to grow by around 1% in 2013. The U.S. GDP (partly due to the growth in population) is expected to grow faster than the advanced economies' average, by 2.1%. As for the developing economies, the Asian, Sub-Saharan, Latin American and Central and Eastern European economies are forecast to grow by 7.2%, 5.7%, 3.9% and 2.6%, respectively.

For the period between 2010-2013, the GDP growth rate can be expressed as one-fifth of the export growth rate plus 4.5 per cent in the advanced economies and one-fifth of the export growth rate plus 0.8 per cent in the developing economies. The three main components of the growth above export growth are the increase in population, the rate of investment and the ratio of public debt. The average investment rate in the developing economies (approx. 36%) is double that in the advanced economies (approx. 18%) [The inflation rates for 2010-2013 are basically the same as the GDP growth rates for the respective regions (developed vs. developing)].

The ratio of public debt to GDP in the advanced economies was 40% in the period between 1880 and 1920. It rose to 120% between 1920 and 1925, dropping relatively evenly to 40% by the 1970s and rising, also relatively evenly, to around 100% today. According to the IMF, a 1% fiscal adjustment would cost more than 1% in GDP growth. Yields on government bonds follow a simple rule: the higher the public debt and the less the per capita GDP, the higher the yields .

There are two specific relationships than can be observed in the operation of the world economy in the past 13 years. The advanced economies have spent a significantly lower part of their GDP on investment than the developing economies (20% vs. 28%), their export growth rate has been significantly lower (4.4% vs. 7.4%), their expenditures-to-GDP ratio higher (41% vs. 28%) and their public debt higher (84% vs. 41%) than in the develop-

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

ing economies. The annual current account deficit in the advanced economies was of 0.7%, while that in the developing economies showed a 2.3% surplus. The ratio of per capita GDP in the advanced economies to that in the developing economies grew from 8.6 in 1980 to 10.0 in 1990 and then fell to 6.5 by 2012. In short: in the past one and a half decade, the over-consuming advanced economies with twin deficits have been financed by the developing economies with twin surpluses, while the ratio of per capita GDP in the advanced economies to that in the developing economies has halved.

1.2. The macro-economic environment in Hungary, recession, long-term negative outlooks, stagnation

GDP in Hungary continued to fall in Q3 2012, although some encouraging signs can be seen: a) out of those EU member states, where GDP fell in all three quarters of the year, Hungary saw the lowest decrease in Q3, b) the contribution of industry (including manufacturing) to GDP stopped dropping, the share of the construction and the information technology and communications industries in GDP rose by 0.1% and 0.2%, respectively, c) in the use of GDP, exports as well as public consumption grew and d) the number of new private cars licensed rose in all three quarters year on year.

GDP in Hungary fell in each of the first three quarters of 2012, as was the case in seven other EU countries (the Czech Republic, Greece, Cyprus, Italy, Netherlands, Slovenia and Spain). The lowest declines were recorded in Q3 in Hungary and Spain (1.5% each).

In terms of crisis management, these eight countries can be categorised in four groups:

- The Czech Republic and the Netherlands, increasing exports and investment, paying a relatively low interest and restraining consumption to a less extent. [Active crisis management]
- Spain and Italy, increasing exports, reducing investment and either slightly reducing consumption or paying a relatively low interest. [Partly active crisis management]
- Greece and Cyprus, increasing exports, reducing investment, paying a relatively high interest and significantly restraining consumption. [More passive crisis management]
- Hungary and Slovenia, reducing investment, not increasing exports, paying high interests, and Hungary more, Slovenia less significantly, reducing consumption. [Passive crisis management]

Compared to 2007, investment in Hungary fell by 10% in the private sector, 23.1% in the public sector and 18.6% overall in the economy. The rate of employment rose by 1.1 percentage point to 51.4%, while the rate of unemployment decreased by 0.3 percentage points to 10.4% year on year in Q3 2012. The number of those employed rose by 113,000 to 3,935,000. Family tax benefit adjusted real earnings fell by 3.6% in Q1-Q3 2012 year on year. Consumption in Q3 fell by 3.9% year on year, a rate not lower than that in the PIIGS countries.

Exports in euro terms rose by an annual 2.3% in 2011 and 2012, exactly the same rate as the rise in consumer and industrial producer price indices in the euro area as of October 2012. Hungarian exports in real terms have been stagnant for the second consecutive year, the increase in revenues mainly comes from price increases. Industrial production in October 2012 was at the level of October 2010. Seasonally and calendar adjusted industrial production in October 2012 dropped by 3.8% year on year. Total sales fell by 2.5% (domestic sales by 5.7%, export sales by 0.7%). Construction production fell by 3.8% year on year between January and October 2012, although the second half of the year saw some increase. Seasonally and calendar adjusted construction production was up 7% in July, down 4.3% in August and up 5.3% in September.

1.3. Performance of the Hungarian banking sector, facts Q1-Q3 2012, forecast for the year

Total assets in the banking sector were at HUF 30,169 billion as of September 30, 2012, 90% of total assets in September 30, 2011. The net stock of *loans* fell by 16% (including corporate loans by 11% and retail loans by 18%), the stock of securities rose by 1% in the period between September 30, 2011 and September 30, 2012. According to the relationship between GDP growth rate and corporate loans in the period between 1994 and 2012, a 3% drop in corporate loans in real terms entails a stagnation in GDP, a 6% decline causes a 1% drop in GDP, while a 9% drop leads to a 2% fall in GDP in the medium-term.

Banks' liabilities fell by HUF 3,169 billion in Q1-Q3 2012 year on year. Three-quarters of this decline was in foreign currency and a quarter in HUF. 54% of the decline came from interbank deposits, 35% from loans taken and 14% from debt securities. The stock of deposits fell by 1%, with corporate deposits dropping by 3%. The loans-to-deposits ratio declined by 27 percentage points to 131%. The role of deposits in the decline is negligible. Banks' capital adequacy ratio rose by 2 percentage points to 14.71%.

Profit after tax in the sector fell from a positive HUF 57 billion in September 2011 to a negative HUF -10 billion in September 2012 (this figure may still change by December 31 and during the audits). This decline can be explained by the HUF 41 billion decrease in net interest income, the HUF 139 billion drop in commissions+dividens+investment services, the HUF 3 billion increase in operating expenses and the HUF 150 billion decrease in other non-interest income, while the change in impairment and provisions showed a HUF 17 billion improvement. Extraordinary profit dropped by HUF 32 billion, ordinary tax liabilities fell by HUF 15 billion.

The quality of classified loans clearly deteriorated: calculating with averages, based on the portfolio, the change in impairment should have been -HUF 188 billion as opposed to the +HUF 17 billion posted. The difference is partly offset by the HUF 82 billion in reversals due to excess provisions made in 2011 and the HUF 134 billion in other Other Non-Interest Income items. Following the shock of the Early Repayment Scheme, these items will be finally allocated to the appropriate items in the audited balance sheets and profit and loss accounts.

With the banking sector making no profits, corporate lending continues to drop, partly due to the lack of demand and partly because the Hungarian bank tax crowds out SMEs, which are considered as riskier borrowers. The barely 3.2% real ROE produced by the banking sector on average over the past 18 years does not warrant the levying of any bank tax.

2. Major changes affecting the sector

2.1. Retail banking

2.1.1. Extension of the Exchange Rate Cap Scheme

The banking sector followed closely the take-up of eligible customers in the Exchange Rate Cap Scheme. As of the end of the year, more than 100,000 customers joined the scheme. Banks supported the government's proposal and the subsequent Parliamentary decision to extend the deadline for joining the scheme till end-March. The banking sector maintains its estimate that 50% of the eligible customers will join.

Number of homes purchased by the National Asset Management Company:

The National Asset Management Company received 1,970 offers for sale and signed 600 purchase contracts in 2012. It expects 13,000 additional homes to be offered for sale in 2013, of which it will be able to purchase 10,000 from the HUF 33 billion allocated for 2013. The NAMC plans to purchase 25,000 homes in all by the end of 2014.

2.1.2. Bank cards

Visa's joining on the issuer side the contactless cards business in Hungary was a breakthrough in the Hungarian bank cards market in the last months of the year. One Hungarian bank has already announced its plan to fully migrate its plastic cards to the contactless technology. Chip migration has been essentially completed. Those not commencing migration in the past months have also agreed on the timetable. In the case of most banks, the only constraint to full migration is the expiry/renewal dates of the cards. (The migration of ATMs and POS-terminals was completed long ago).

Banks' bank card systems continued to work smoothly throughout the Christmas period, coping with the increased number of transactions. While the chip technology has added significant security to plastic card payments, special caution should be exercised with online purchases (hitting their peak in the weeks before Christmas): according to statistics, most frauds are concentrated on the "card not present" transactions. At the joint initiative of several working groups of the Association, we issued a communication before Christmas, drawing attention to the dangers and providing practical advice on how to make online purchases safer.

A press report in December revealed that VISA had approached the Ministry for National Economy, threatening to pull out of the Hungary because of lower interchange fees. Although major financial portals had indicated from the outset that it was its own commitment that pushed VISA into a disadvantageous position and a "pull out" could not be carried out anyway, after this move the Ministry requested the MNB to prepare (based on its previous proposals) a proposal for the regulation of interchange fees in Hungary. We made steps to get our professional arguments to the drafters of the legislation.

2.2. Corporate lending

2.2.1. Investment loans

The annual investment volume index in Hungary showed a 5.9% decline in the second quarter of 2012 and continued to fall in Q3. According to seasonally adjusted data, the volume of investments in the economy dropped by 1.1% in Q3 over Q1. In the first three quarters of 2012, the volume of investments was down 5.2% from the base period. According to data of the Central Statistical Office, the slowdown in the decline on an annual basis was due to investments in manufacturing rising again (+3.8%) and the volume index of the transport and warehousing sector investments increasing (+9%). Investments in machinery and equipment rose by 3.7%, primarily due to the growth in agriculture and manufacturing. Investments in the rest of the economic sectors continued to fall in the third quarter of 2012. With the completion of EU co-financed projects, investments in human health care and education fell to four tenths and six tenths, respectively.

As was the case in the 2nd quarter, overdraft facilities continue to play an increasingly important role in corporate lending: companies mainly borrow to finance their working capital needs and daily expenses, borrowing for investment projects is less significant.

With the deteriorating economic environment, growing tax burdens and tight lending standards, the MNB adjusted its corporate lending forecast, projecting a 5.3% and 4.1% decline in corporate lending in 2013 and 2014, respectively. The Central Bank expects substantive growth in 2015 at the earliest.

2.3. Municipal lending – consolidation of municipalities with less than 5000 inhabitants.

In 2012, the government recast the laws regulating the day-to-day operations of municipalities and the provisions ensuring the performance of their functions and the framework for their financing was also changed. As a

first step, the government sought to consolidate municipal debts related to day-to-day operations and development projects previously not funded by the state.

To achieve this, based on Act CLXXXVII of 2012, the state provided a one-time non-refundable aid to municipalities with less than 5000 inhabitants and the multi-purpose micro-regional associations of these municipalities, as a repayment support for their debts to financial institutions. (Financial institutions: credit institutions and financial enterprises as defined by Sections 4-6 of Act CXII of 1996 on Credit Institutions and Financial Enterprises. Debts: loans, debt securities and bills of exchange as per Sections 3 (1) a)- c) of CXCIV of 2011 on Economic Stability of Hungary).

The consolidation extends to the full stock of debts (capital, delinquent capital, delinquent interest, other delinquent fees and charges) and charges related to these (interest, commitment fee, handling fee, late interest) existing as of December 28, 2012. The scope of costs subject to consolidation was defined based on the relevant consultations between the government and the Hungarian Banking Association.

In the case of municipalities subject to consolidation as of December 12, 2012, the repayment aid will be disbursed within 60 days from conclusion of the consolidation process, according to a procedure to be determined in 2013.

Pursuant to the government's decision, only 14 municipalities are not involved in the current consolidation process. The partial consolidation of these municipalities will take place in 2013, at rates to be determined at a later stage. The 14 municipalities represent a total debt of HUF 14.5 billion.

Calculated at December 27, 2012 exchange rates, the state assumed debts of 1,710 municipalities to a total value of HUF 74 billion, arising from 3,848 contracts. Pursuant to the relevant procedure, municipalities shall pay HUF 3.5 billion from their "security deposits" to the state. The composition of the 3,848 contracts is as follows:

- 1,693 overdrafts and salary loans (HUF 23.3 billion),
- 110 short-term loan contracts (HUF 1.4 billion),
- 2,002 long-term loans (HUF 29 billion)
- 43 bond issue contracts (HUF 20.3 billion).

As for currency, there were 1,684 municipalities with HUF-denominated debts (HUF 50.5 billion under 3,729 contracts), 97 municipalities with CHF-denominated debts (CHF 94 million under 103 contracts) and 13 municipalities with EUR-denominated debts (HUF 2.9 billion under 16 contracts).

2.4. Financial Transaction Levy

The Financial Transaction Levy, adopted by Parliament on July 9, 2012, was still subject to discussions in the fourth quarter. It became clear that in a number of cases, rulings from the authorities would not suffice to solve the uncertainties arising from ambiguities in the legal text. Hence, a working group set up from payment and legal specialists from member banks drafted specific text proposals to be included in the legislation. The proposals were aimed to address the definition of transactions subject to and those exempt from the levy and the rules for meeting the levy liabilities. The proposals were submitted to the Ministry for National Economy. Several of our proposals were accepted and the legislation (taking effect on January 1, 2013) was amended twice, on November 29 and December 7.

The real change under these amendments was not the technical adjustments need from banking points of view, but the revocation (as a result of international pressure) of the levy on certain central bank transactions and the ensuing doubling of the levy rates to make up for the missing budget revenue (including an outstandingly high levy rate on cash transactions, aimed at curbing cash payments). As a result, the general levy rate

was raised from 0.1% to 0.2% and that for cash transactions from 0.2% to 0.3%, both subject to a cap of HUF 6,000 per transaction. It was also announced that the exemption of securities and investment transactions will cease once the EU Directive on a Financial Transaction Tax is adopted, after which the EU legislation will apply.

As requested by the Association, in the first week of January 2013 we received the draft form for the monthly tax returns on the financial transaction levy (to be first submitted by February 20, 2013). In our comments on the proposed form we pointed out that the data requested were too detailed. The required breakdown by HUF and foreign currency transaction, number and value (separately for those under and those over HUF 6,000), payment method, and transactions subject to levy and those exempt, is impossible to be met by banks by the tight deadline set. Banks' systems would require substantial development work to be able to generate these data. In addition, in relation to a number of data, the required guides are missing or adjustments to the legislation would be needed. We proposed that a three-month preparation time should be allowed for banks to carry out the required system developments. We requested the Economy Ministry's action with the Tax Authority to achieve this.

We also asked for the assistance of PSZÁF in identifying those institutions and firms that fall into those financial categories which are exempt from the levy. We requested PSZÁF to provide us with a list of licensed institutions listed on its website so that banks can automatically check the exempt status of the institution in question. We proposed a consultation to identify the exact needs and requirements.

We requested rulings from the Ministry in relation to technical implementation and interpretation of the text of the legislation on the financial transaction levy. The rulings received were communicated to all members.

2.5. MNB measures related to FX swap portfolios

After exchanges of letters on this issue, raised by the MNB in July, the parties held an expert-level meeting in October. At this meeting, the banking sector reiterated its critical comments and the parties discussed the method of self-regulation proposed by the MNB. In accordance with the agreement made at the meeting, the Association collected member's opinions on their willingness to sign the self-regulatory commitment statement drafted by the MNB. According to our knowledge, the MNB is conducting direct consultations with a number of those banks affected.

Since banks had different opinions on the issue, a second expert-level meeting was held in the second week of December. Since a division of opinions remained also after this meeting, we requested more time for consultations within the sector to try to reach agreement. An alternative text proposal is now being circulated to obtain banks' views. Consultations with members are ongoing.

3. Government measures, regulatory changes

3.1. Supreme Court Legal Unity Working Group working document on unilateral contract amendments, comments of the Association

The Supreme Court's working document on unilateral contract amendments was aimed to provide guidance to courts based on final court decisions adopted on the issue. The working document summarised the aspects and requirements concerning the judging of unilateral contract amendments. The Supreme Court sent us the document for review. We provided comments on the document in several rounds. In our comments we drew attention, inter alia, to the need to specify the scope of the document, the lack of clarity on the definition of normal business risk, and the conflict between the working document and previous decisions of the Supreme Court. We expressed our view that it would be wrong to apply the Civil Code provisions on unfair contracts and the judicial amendment of contracts instead of the sector regulation effective at all times. We participated in

the conference held on the working document and organised meetings for banks' legal counsels on the issue. The working document was adopted with minor modifications, but no major changes, at the Supreme Court's Civil College meeting of December 10, 2010. The Association started reviewing the implications of the relevant Civil College Opinion No. 2/2012.(XII.10.) PK with banks' legal counsels at a meeting led by Daniel Gyuris, Vice-President.

3.2. Interpretation issues related to the legislation on branches of foreign companies

Act CLI of 2012 has amended the legal status of branches of foreign companies. Pursuant to the new legislation: "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 legal status of financial branches of foreign companies was also amended: "A financial branch of a foreign company registered in the EEA may, without any special authorisation, act on behalf of the foreign company, and in this case the provisions of Sections 10 (1) and (2) shall not apply. The fact of the financial branch acting on behalf of its founder shall be indicated in its business terms and conditions and in the course of its operations and in any procedure conducted under its name." In our opinion, the fact that the new legislation allows a financial branch to act in its own name as well as on behalf of its founder is questionable from both consumer protection and legal certainty points of view.

In a letter to the Ministry for National Economy, we again drew attention to the contradictions between the new provisions. At a meeting with the responsible Deputy State Secretary we received a promise that the Ministry would once again approach the Ministry of Justice on the issue.

3.3. Hungarian financial Supervisory Authority (PSZÁF)

3.3.1.Recommendation on customer complaint handling procedures

At PSZÁF's request, we provided comments, based on members' observations, on the supervisory authority's proposed recommendation on customer complaint handling.

We pointed out that it was unclear why such a recommendation (with minimum new information compared to the existing regulations) was needed in addition to the detailed complaint handling procedures stipulated in the Banking Act and the Supervisory Authority's decree on complaint handling.

Despite our relevant proposals, PSZÁF did not change those provisions of the recommendation, according to which

- even those cases which could be easily settled will be subject to a bureaucratic procedure,
- in cases which are legally unclear, it should be for the bank to decide whether the settlement of the case requires a supervisory complaint procedure or a Reconciliation Board procedure,
- it will be impossible to take action against serial complainers misusing the complaint handling procedures.

Meanwhile, PSZÁF did accept or proposal that

- there should be no requirement to provide information on the status of a case any time the customer so requests, and
- it will be the bank's discretion to appoint the unit responsible for the monitoring of complaint handling procedures within the bank.

3.3.2. Proposed supervisory decree on remunerations

We received for review the proposed decrees on reporting requirements regarding the remunerations of management and staff members on very short notice on November 14. The proposals were reviewed with the involvement of the Association's HR Working Group.

Our main objections to the proposals include the individual identification of the details of managers with remunerations exceeding HUF 300 million as required by the data structure of the report, the uncertainties regarding the classification of employers by business division, the extremely short deadline provided for the reports on 2011, the inconsistent definition of annual remuneration and the exchange rates to be used. The final decrees were published in the middle of December. These took little account of our proposals, for example the deadline for 2011 reports is only slightly more than 30 days.

At the beginning of January, we held a meeting to discuss our objections and to identify the actions needed for compliance with the reporting requirements. The meeting was attended by representatives from PSZÁF, who provided detailed guidance regarding the classification problems. As for the other issues raised, PSZÁF said they were bound by the relevant EBA recommendation, that is why they could not accept our proposals.

3.3.3. Recommendation on debt collection

The Supervisory Authority drafted a recommendation on consumer protection requirements for banks in debt collection procedures. The recommendation is aimed to promote cooperative and fair attitude between banks and delinquent debtors. The recommendation will only apply to retail debts. Debt collection is defined by PSZÁF as an activity aimed to enforce a delinquent claim arising from the provision of financial services on a commercial basis. The recommendation formulates general principles for debt collection: the principle of cooperative and fair attitude, the principle of due care, the principle of information provision, the principle of taking into account the debtor's financial capacity and the principles of gradualness and regulated procedure. Furthermore, the recommendation provides best practices for debtor information and liaison. It provides sample information materials to be used in case of payment difficulties, pre-termination debtor information and other useful information.

We conducted extensive consultations on the proposed recommendation with banks' debt collection officers, as well as with financial firms and the Association of Hungarian Debt Collectors (MAKISZ).

We gave comments on the proposed recommendation in several rounds. We proposed that the scope of the recommendation should be clearly defined. We also proposed that the recommendation should allow for a differentiated treatment between cooperative and non-cooperative debtors and the application of the principle of rationality in customer information. (All information should be available upon inquiry from the customer, but it should not be required to repeatedly provide the customer with full legal information in each and every stage of the debt collection procedure). We provided specific proposals regarding customer information and contacting, liaising and settlements with the debtors.

The recommendation has been issued, PSZÁF is going to invite the affected organisations for a technical consultation in the near future.

3.4. Newly created office: Financial Ombudsman

The newly created office of financial ombudsman is a financial consumer protection instrument, more or less proven in other countries. Hungary chose another path when it assigned consumer protection functions to the Hungarian Financial Supervisory Authority and set up the Financial Reconciliation Board for dispute resolution. That is why it came somewhat as a surprise when, after an announcement by the Prime Minister in the autumn, the Parliament created the position of financial ombudsman, with powers set by a Government Decree. In principle is should be a positive fact that there are more institutions where the customer can to turn to in case of complaints. Therefore, in commenting on the relevant Act and Government Decree, the Association

welcomed the new actor in financial consumer protection, and the critical comments we made were only aimed at improving the legal quality of the regulations.

3.5. Amendment to the APR Decree

With the revision of the EU APR regulation, the relevant Government Decree also needs to be amended. The debates during the drafting of the revision to the EU Directive (in which the Association was actively involved) already projected that the transposition of the compromise text into national legislations may cause problems.

The main change is in the APR for revolving loans with indefinite maturities, that is, overdrafts and credit cards.

The main problems in interpreting the proposed Government Decree were as follows:

- it was not possible to clearly identify the products subject to the regulation,
- in the case of credit cards, a requirement contrary to the real-life practice was set, whereby the APR would have automatically exceeded the statutory ceiling, and
- it was not possible to differentiate between overdrafts and credit cards associated with a payment account.

The Ministry for National Economy was receptive to our comments:

- it included a provision that in calculating the APR, the bank's terms and conditions should be governing (thereby avoiding unrealistic APRs),
- it held a meeting with the Association and PSZÁF to settle the remaining issues. The minutes of this meeting are considered as governing by all three parties.

3.6. Amendments to the Act on Central Credit Bureau, first meeting of the Credit Bureau Working Group

At the request of the manager of the Central Credit Bureau, BISZ Zrt., the Association set up a Working Group on Central Credit Bureau. At its first meeting, the Working Group reviewed tasks related to the autumn amendments to the Act on Central Credit Bureau and experience of the launch of the positive-list system.

The working group established that

- Despite the extremely short time provided for banks and BISZ to upload and launch the system, the system was successfully launched, not least thanks to the project led by the Association.
- As a result of the new statutory requirements, the volume of data stored in the Central Credit Bureau grew substantially (in addition to negative data, the system now includes positive debtor data). This meant extensive data processing tasks in the initial stage. In the next stage, the main task - and primarily for the data providers - should be to improve the quality and accuracy of the data in order to reduce the need for subsequent corrections.
- Based on proven market practices, BISZ plans to restructure its most important service, the loans report, to ensure that users can efficiently use in it in their decisions.
- A compromise solution was reached between banks and BISZ on tasks arising from the 2012 law amendment and on the schedule for the required systems changes. (Banks' busy year-end period will be taken into account in setting the implementation dates).

Following this first meeting, the Working Group agreed to hold regular meetings to review current issues.

4. Communications – Key themes in Q4

Based on the decision of the Board, the Association conducted a communications campaign in the fourth quarter to promote the Exchange Rate Cap Scheme. Running between November 16 and December 12, the campaign started with media appearances and continued with targeted articles in the online media. According to the analysis on the campaign, advertisements and articles appeared in 1 048 208 instances, reaching 427 447 individual users. The number of applications for the scheme rose during the campaign: as of the end of November, the number of participants in the scheme exceeded 100,000. An additional task in communications was to convey the position of banks on the extension of the scheme. We managed to convey the clear message that banks were supportive of the extension to end-March of this scheme, regarded as a key element of helping debtors in distress.

In relation to the financial transaction levy, banks were required to publish the relevant changes in their terms and conditions 60 days in advance. In its communications, the Association made it clear that these actions were necessary due to the regulatory changes. It is attributable to this that there was no major criticism from the press for banks changing their new terms and conditions for a second time due to the last-minute changes in the legislation. Media comments show that journalists have "accepted" banks' position of incorporating the levy in their prices to various extents and with different timetables according to their business policies and in compliance with the relevant laws. Banks' position was reinforced by the communications of PSZÁF pointing out that banks had the right to pass on the levy subject to the relevant conditions.

The Association continued its Press Club events in the fourth quarter. The presentation of the collection of essays and the financial glossary published on the 25th Anniversary of the two-tier banking system in Hungary was also an opportunity for the Secretary-General to explain the views of the banking community on current issues at an informal background conversation. The Association's appearance in the media was continuous, with 560 appearances in the fourth quarter. The most frequent were our appearances in the online media, followed by the print and electronic media. In 2012 we had a total of 4500 appearances and mentions in the Hungarian media.

5. International developments

5.1. Prudential regulation

In the fourth quarter, the European Union and the European Banking Federation continued to discuss the priorities addressed earlier during the year. The actions announced in June for the creation a Banking Union were not implemented, and the proposed Single Supervisory Mechanism is only expected to be introduced in March 2014. The ECB will be the ultimate supervisory authority for all euro-zone banks, however, the practical supervision of less significant banks will be exercised by the national authorities. The EBF continued to advocate for a single supervisory mechanism, with a Single Rule Book, while retaining the EBA's role of rulemaking and ensuring supervisory convergence.

After the publication of the Liikanen High Level Expert Group report on reforming the structure of the EU banking sector, the European Commission will make a proposal in the first half of 2013 for measures to be taken at the EU level. These will presumably include the mandatory separation of trading activities over a certain threshold. The EBF maintains that there is no compelling case for the mandatory separation of trading activities, the universal banking model is viable. The EBF maintains its position that implementation of the ongoing regulatory reforms should be awaited before considering any potential reform of the structure of the banking sector.

Despite earlier promises, the CRR/CRD4 trilogue[2] was not concluded under the Cypriot presidency. The trilogue continues in 2013. The key issues to be addressed by the Irish presidency include the flexibility package for national buffers, the liquidity ratio, remuneration, credit valuation adjustment and the relaxing of the capital requirements for SMEs. The European Banking Federation continues to lobby for its position on these remaining issues. According to current information, the European Parliament is expected to vote on the package on March 11-13, 2013. Although the current text provides for an immediate entry into force, there is a good chance that it will be postponed to January 1, 2014.

The European Parliament is expected to develop a position on the Bank Recovery and Resolution Directive in early 2013. Accordingly, the relevant trilogue has also been postponed to 2013. Member state efforts are mostly aimed at relaxing the Directive and providing for more national discretions. The EBF is opposed to this and continues to advocate for maximum harmonisation of the recovery and resolution frameworks.

In addition to prudential issues, key issues addressed by the EBF include the proposed revision to MiFID, the proposed FTT, the obligations ensuing from the FATCA, and the regulation on Package Retail Investment Products (PRIPs).

Main developments in global regulation included the Financial Stability Board's report on financial regulatory reform, the Basel agreement on Liquidity Coverage Ratio and the re-regulation of the capital requirements for securitisation.

5.2. Review of the EU Payment Services Directive, position of the Hungarian Banking Association

The European Commission launched a review of the Payment Services Directive adopted in 2008 to check if the treatment of new products and market players is appropriate in the PSD. If these new products have a significant share in the market, then the rules for market entry, oversight and consumer protection should be extended to them as well.

The Association's Payments Working Group reviewed the potential amendments that may be required:

- The Working Group supported a better separation of the liability rules for bank cards from those for other electronic payment instruments, to ensure that in the case of e-payments, which are undergoing continuous innovation, banks are allowed to require customers to implement special security requirements to prevent increasingly frequent frauds.
- To provide for flexibility in the course of business, the Working Group proposed that the notice time for changes affecting the customer should be set at less than two months.
- The Working Group supported the proposal that detailed liability rules should be provided for service providers providing intermediary services between banks and customers (such as EBPP),
- The Working Group did not support the extension of EU rules to non-EU transactions, given that due to differences in the regulatory environments, these stricter rules cannot be enforced in non-EU jurisdictions and those subject to these rules may be put at a competitive disadvantage.

We communicated these points to the EBF and the EBF included our comments in its position to be submitted to the European Commission.

6. Other developments affecting the banking sector

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

6.1. FATCA

Accepting our proposal, the government decided to initiate an inter-governmental agreement with the U.S. (as some other EU countries have already done) for providing the data required by the U.S. authorities with a view to preventing tax avoidance by U.S. taxpayers and to take the necessary legislative steps. Certain institutions and products, where there is no chance of tax avoidance can by definition be exempted from FATCA reporting. We submitted a proposal for thes institutions and products.

6.2. Electronic Payments and Settlements System (EFER) project

The government body responsible for the Electronic Payments and Settlements System requested the Association's assistance to ensure that banking aspects are duly taken into consideration during the preparation of this government project and thus the greatest possible number of banks can join.

A main objective in the EFER project is to radically reduce the number of credit transfers made to wrong account numbers in payments to government agencies (Land Office, Tax Office, courts, etc.). This would be achieved by the customer, specifying online, on the relevant government agency's website, the items to be paid (for examples, different charges payable in case of car transfer, tax payments including several elements), followed by the government agency sending a payment message form to the customer's home banking address. All the customer will need to do is approve the payment, which is thus guaranteed to go the right account number.

A new task from a banking point of view will be the forwarding of the government agency's message to the bank's home banking/online banking system. Since this should be done in a fast and secure manner, we proposed that the government body responsible for the project should look into the possibility of involving and adapting GIRO's systems for this purpose. The discussions are still in progress as of the closing date of this report.

6.3. Cooperation with the Office of Ombudsmen

Under a project called "Losers of the Crisis", the Ombudsman for Fundamental Rights organised a workshop titled "Responsible State, Conscious Citizen". The Association was also invited to the workshop. The themes of the workshop were diverse, including the ombudsman's investigation on foreclosure costs, which involved the banking system. The Association's representative gave a short briefing on banks' experience regarding foreclosures.

At the beginning of 2013, the Ombudsman for Fundamental Rights launched a comprehensive investigation on judicial foreclosures, including the safeguards for creditors and debtors, operations of the Hungarian Association of Bailiffs and practical experience of foreclosures of various assets (chattels, real estate).

6.4. Complaints, requests for assistance, advice

As was the case in the previous quarters of the year, we continued to receive a lot of approaches from customers seeking assistance or advice or help regarding the handling of their complaints. Most requests were related to the Exchange Rate Cap Scheme, many saying that they would like to continue repaying their loans, but they do not have the money to pay for the current repayment amount, while their banks do not accept a lower repayment amount. All customer inquiries were answered, those appearing legitimate were forwarded to PSZÁF.

ANNEX - International developments: Regulation, Supervision, European Banking Federation

1. Global regulation

1.1. Financial Stability Board (FSB) report to the G20 finance ministers and central bank governors on the progress of financial regulatory reforms

The FSB report of October 31 addresses the following issues: strengthening the oversight and regulation of shadow banking activities, building resilient financial institutions, ending "too big to fail", completing OTC derivatives market reforms, development of a Global Legal Identifier System, addressing data gaps revealed by the financial crisis, enhancing the risk disclosure of major banking institutions, reducing reliance on credit rating agencies and monitoring the effects of reforms on emerging markets and developing economies.

Strengthening the oversight and regulation of shadow banking activities

The FSB, the BCBS[3] and the IOSCO[4] have developed separate recommendations on shadow banking. Their starting point is that authorities should approach shadow banking in a balanced and targeted manner. The objective is to ensure that shadow banking is subject to appropriate oversight and regulation to address bank-like systemic risks that arise outside the regulated banking system, while not inhibiting sustainable and resilient non-bank financing models.

Accordingly, the recommendations aim to

(i) to mitigate the spill-over effect between the regular banking system and the shadow banking system,

(ii) to reduce the susceptibility of money market funds to "runs",

(iii) to assess and mitigate systemic risks posed by other shadow banking entities,

(iv) to assess and align the incentives associated with securitisation to prevent a repeat the creation of excessive leverage in the financial system, and

(v) to dampen risks and pro-cyclical incentives associated with secured financing contracts such as repos and securities lending.

In addition, vigilant oversight of shadow banking activities is required to respond to inevitable market mutations.

The FSB launched a public consultation on these recommendations on November 18. Based on this consultation and the relevant impact studies, a final set of recommendations is expected to be presented to the September 2013 G20 summit in St. Petersburg.

Building resilient financial institutions

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[3] Basel Committee on Banking Supervision

[4] International Organization of Securities Commission

The core of the Basel III agreement is the recognition that building more resilient banks requires higher and better quality capital. According to the Basel Committee's survey, only 8 of the 27 member jurisdictions have implemented Basel III from January 1, 2013. This means that only 6 of the 28 global systemically important banks identified by the FSB are subject to the Basel III regulations from the globally agreed start date. The report emphasises that all jurisdictions should redouble their efforts to pass legislation that is consistent with the Basel III framework.

Ending „too big to fail"

In the wake of the crisis, the problem of bailing out large banks from taxpayer funds and regulations to prevent this came to the forefront. Key measures include the development of effective resolution regimes, mandatory recovery and resolution plans for global systemically important financial institutions (SIFIs), requirements for global systemically important banks (G-SIBs) to hold 1% to 2.5% additional capital, to be phased in by 2019, and more intensive, effective and proactive supervision of SIFIs. As requested by the G 20 leaders, the FSB and the BCBS completed the policy framework for domestic systemically important banks (D-SIBs) in October. Public consultation will be launched on global systemically important insurers (GSIIs). The CPSS and the IOSCO have finalise principles for Financial Market Infrastructures (FMIs) and are currently working on the assessment methodology, disclosure framework and resolvability of FMIs. A proposal for the identification of non-bank SIFIs will be published in 2013.

OTC derivatives market reform

As a result of the crisis, reforms have been implemented in the OTC derivatives market with all standardised derivatives centrally cleared. All FSB jurisdictions have declared their commitment to this approach, which is expected to improve transparency, reduce systemic risks and protect against market abuse. At the same time, the FSB urges regulators to

- identify the cross-border application of rules to infrastructure, market participants, and products,
- identify concrete examples of any overlaps, inconsistencies and conflicts, and
- develop options for addressing these issues.

Enhancing the risk disclosure of major financial institutions - Final report of the EDTF

In October, the Financial Stability Board's Enhanced Disclosure Task Force (EDTF[5]) published its report on enhancing ongoing risk disclosure practices by banks. Members of the EDTF include both producers and users of bank disclosures. The recommendations made by the Task Force are aimed to enable users to better understand the following key areas:

- a bank's business models, the key risks that arise from them and how those risks are measured;
- a bank's liquidity position, its sources of funding and the extent to which its assets are not available for potential funding needs;
- the calculation of a bank's risk-weighted assets (RWAs) and the drivers of changes in both RWAs and the bank's regulatory capital;
- the relationship between a bank's market risk measures and its balance sheet, as well as risks that may be outside those measures; and

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[5] For more on the EDTF, see Section I.5 of the Annex to our Q2 report and Section I.1 of the Annex to our Q3 report.

- the nature and extent of a bank's loan forbearance and modification practices and how they may affect the reported level of impaired or non-performing loans

The EDTF expects its recommendations to be applied by large global banks after 2013. However, some recommendations may be applied earlier by a wider range of banks subject to their risk profiles.

The FSB has urged international industry associations to support the disclosure principles proposed by the EDTF.

The EBF Executive Committee welcomed and symbolically expressed its support of the EDTF's report, without committing to its adoption. (The IIF is expected to provide a similar response).

Other regulatory measures

The proposed Global Legal Entity Identifier (LEI) is expected to be introduced in March 2013. Concurrently, the BIS will start collecting the missing data at the banks' level. Work is in progress to harmonise accounting standards, a report is expected in the summer of 2013. The FSB has developed a roadmap with timetable to reduce reliance on credit rating agencies. Meanwhile, assessments are being conducted on any unintended effects of the reform on emerging market and developing economies.

1.2. Revisions to the Basel Securitisation Framework, consultative document published by the Basel Committee

The (disappointing) performance of securitisations and the central role they played during the financial crisis were a key motivation for the Basel Committee to perform a broader review of its securitisation framework for regulatory capital requirements. The Committee's objectives are to make capital requirements more prudent and risk-sensitive, mitigate mechanistic reliance on external credit ratings and reduce current cliff effects in capital requirements. In July 2009, the Committee introduced enhancements to the Basel II framework to address deficiencies identified during the financial crisis. These measures are commonly known as Basel 2.5. The major elements of the current proposal include the following:

- Two possible hierarchies that would be significantly different from those employed in the existing securitisation framework. These two proposed hierarchies differ in aspects such as the specific approach to be applied for certain types of exposures, the order and scope of application of approaches and the flexibility that is given either to jurisdictions or to banks to opt for one approach or the other.
- Proposed enhancements to the current ratings-based approaches and the supervisory formula approach that are part of the Basel II securitisation framework. The proposal contains a revised ratings-based approach and a modified supervisory formula approach, both of which are intended to create a more risk-sensitive and prudent calibration. The enhanced approaches also incorporate additional risk drivers, such as maturity.
- The introduction of new approaches, such as a simplified supervisory formula approach and different applications of the concentration ratio-based approach that was included in the Basel 2.5 enhancements.

The Basel Committee plans to soon publish a more complete and technical discussion of the modelling and recalibration work underpinning the proposed revisions to the securitisation framework. Also, it will conduct a quantitative impact study (QIS) on the proposals. Comments on the proposals are invited by March 15, 2013.

1.3. Basel Committee document on the Liquidity Coverage Ratio (LCR) and liquidity risk monitoring tools

At the beginning of January 2013, the Basel Committee's governing body, the Group of Central Bank Governors and Heads of Supervision (GHOS), endorsed the Committee's revised guidance on LCR and liquidity risk monitoring tools. The revisions to the LCR incorporate amendments to the definition of high-quality liquid assets (HQLA) and net cash outflows. In addition, the Basel Committee has agreed a revised timetable for phase-in. The LCR will be introduced as planned on 1 January 2015, but the minimum requirement will begin at 60%, rising in equal annual steps of 10 percentage points to reach 100% on 1 January 2019. The LCR is aimed at ensuring that a bank has an adequate stock of unencumbered high-quality liquid assets (HQLA) that can be converted into cash easily and immediately in private markets to meet its liquidity needs for a 30 calendar day liquidity stress scenario. Once the LCR has been fully implemented, its 100% threshold will be a minimum requirement in normal times. During a period of stress, banks would be expected to use their pool of liquid assets, thereby temporarily falling below the minimum requirement. Since deposits with central banks are the most - indeed, in some cases, the only - reliable form of liquidity, the interaction between the LCR and the provision of central bank facilities is critically important. Therefore, the GHOS agreed that the Committee would continue to work on this issue over the course of 2013. Mervyn King, Chairman of the GHOS pointed out that with the LCR, for the for the first time in regulatory history, a truly global minimum standard for bank liquidity is being introduced. A phased timetable for the introduction of the LCR will reaffirm that a bank's stock of liquid assets are usable in times of stress, while ensuring that the new liquidity standard in no way hinders the ability of the global banking system to finance a recovery.
The Basel committee's document is made up of two parts. The first part addresses issues related to the objectives of the LCR, its definition, the stock of high quality liquid assets, cash outflows and inflows and application issues for the LCR. The second part addresses the monitoring tools, including the contractual maturity mismatch, the concentration of funding, the available unencumbered assets, LCR by significant currency, and market-related monitoring tools.

In a press release, the European Banking Federation welcomed the GHOS decisions on the LCR, pointing out that they are consistent with the requirements in difficult economic times.

2. European Union

2.1. European Commission response to the Basel Committee's Basel III regulatory consistency assessment[6]

The European Commission considers it of utmost importance that the Basel III agreement is implemented consistently around the world and supports the Basel Committee's intention to regularly assess consistent implementation. At the same time it believes that the assumptions about deviations from the accord have not been made consistently in relation to the three jurisdiction (Europe, USA and Japan). The Commission believes that it is unfounded to qualify the entire IRB approach as unsuitable due to the permanent partial use. Addressing the various details (the definition of common shares, the treatment of investments in insurance entities, loss absorbency at point of non-viability, minority interest, non-joint stock companies), the European Commission argues that the definition of capital in CRD4/CRR is consistent with the capital definition provided in the Basel accord.

[6] For details on the Basel III regulatory consistency assessments see Section I.4 of the Annex to our Q3 report: "In Europe, the definition of capital and the application of permanent partial exemptions from the IRB approach were graded as non-compliant...".

2.2. EP rapporteur report on the proposed Bank Recovery and Resolution Directive (BRRD)

The EP rapporteur published his report on October 17, making the following key points:

- The state has to play a role in a systemic crisis as the last safeguard against failure.
- Resolution and supervisory authorities should be separate.
- One has to be realistic on how banks can prepare for a systemic crisis and therefore scenarios for RRPs should be scaled down.
- Shareholders should have full control during recovery phase but with an intensified supervisory dia-logue.
- The appointment of special managers should be moved to the resolution phase - Issues of resolvability should be addressed in the supervisory process.
- The early intervention trigger should be a harmonised capital level defined in CRD 4, but institutions should be allowed to draw down their buffers.
- Liquidity triggers should be avoided due to systemic risk.
- "Close to failure" is poorly defined and could increase uncertainty and systemic risk.
- A thorough impact assessment is needed for bail-in.
- Short-term debt under 6 months should be excluded.
- The bail-in level should be proportionate to RWAs and added to minimum capital levels and buffer in CRD.
- Three additional tools should be added:
    1. Government guaranteed bank liabilities;
    2. Capital injections;
    3. Temporary public ownership

The deadline for amendment motions was December 17, 2012. The amendment motions will be reviewed on January 21 and 22, the ECON vote is expected in February.

The discussion of the proposed Directive in the Council has not yet been concluded. The amendment motions submitted thus far are mostly aimed at relaxing the Directive and providing for more national discretions. The Deposit Guarantee Schemes Directive (DGS) is expected to be reopened when the debate reaches the issue of resolution funding. Then, the two directives will be discussed in parallel.

2.3. Banking Union (SSM[7])

2.3.1 EBF comments on the Banking Union

- The EBF welcomes the proposals for a Single Supervisory Mechanism (SSM). However, it stresses that an important building block to obtain a well-functioning SSM is a "true" Single Rulebook that harmo-nizes rules and ensures consistent outcomes across all 27 member states. The current CRD4/CRR trilogue should take this into account and revert to its initial aim of maximum harmonisation.

[7] Single Supervisory Mechanism

- The role of the European Banking Authority (EBA) must remain the same - to enforce the Single Rule Book for the entire single market and to ensure convergent supervisory practices throughout the EU. The new SSM should not weaken this key role of the EBA.
- The EBF supports the ECB supervising all banks in the Euro-zone. However, for efficiency, the day-to-day supervision of banks should be conducted by national supervisors within the context of a single supervisory approach. In general, the division of tasks between national supervisors and the ECB must be transparent and clear: no grey-zone should prevail going forward (banks must know clearly who their supervisor is for what parts of their business).
- The EBF supports the proposal to phase in the SSM and agrees that it should be possible for non-euro member states to opt-in, although this process should be made more attractive and easier. It is important that non-euro member states that opt in to ECB supervision have the same rights within the Supervisory Board as euro member states. Furthermore, banks from non-euro member states should be supervised based on the same supervisory rules and practices as banks from euro-member states.
- The EBF agrees that there must be clear separation within the ECB between supervisory and monetary policy functions with clear and transparent governance arrangements. Furthermore, the voting system of the Supervisory Board should provide sufficient safeguards against the constitution of political alliances.
- The ECB will become the competent authority for the euro-zone member states in terms of prudential supervision. In this regard, clarity and transparency must be provided for banks in respect of the existing supervisory decisions and derogations granted to member states.
- For home-host issues, EBF welcomes the fact that for participating member states the theme of home-host cooperation will no longer be an issue, as the ECB assumes these responsibilities. However, as long as not all EU member states participate in the SSM, it is important to establish clear rules to ensure that supervisory colleges continue to function properly.
- It is not clear whether the ECB or national supervisors will be responsible for macro-prudential supervision, and hence how these authorities interact when implementing macro-prudential supervision. If the ECB is designated as the macro-prudential supervisor this raises questions on accountability. Furthermore, the role of the ESRB[8] in the new setup should be clarified.
- Banks should not end up paying or reporting twice for local supervision and EU supervision frameworks. A common framework for EU fees and reporting needs to be determined.
- It should be clarified that banks have a right to appeal ECB supervisory decisions. There needs to be an effective and swift mechanism for providing legal protection.
- The proposed implementation timetable should not compromise the quality of banking supervision – especially in the early stages when the BRRD and possibly CRR/CRD4 will not be in place.
- Going forward the right sequencing of the different elements of the Banking Union is key. The Banking Union should be seen as an evolutionary process where a "true" Single Rulebook, the finalising of the directives on BRR and DGS and the establishment of the SSM are necessary steps before considering the next proposed items of the Banking Union, e.g. a Single Resolution Mechanism (SRM).

2.3.2 Debates related to the Banking Union

Member states and the EP rapporteurs proposed a number of changes to the text proposed by the Committee. The most debated issues in the regulation on the ECB were as follows:

- The division of tasks and competences between the ECB and national authorities,
- The voting quotas in the Supervisory Board,

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[8] European Systemic Risk Board

- Separation of the ECB's monetary and supervisory functions,
- To what extent would a non-euro member state be bound if the Governing Council, in which they are not represented, changes the decision of the Supervisory Board?
- The timetable for the extension of ECB supervision.

The voting quotas were also debated in the regulation on the EBA.

The EBF did not support the rapporteur's proposal for a two-tier supervisory system, as this would lead to the fragmentation of the single market and make the implementation of the Single Rule Book more difficult.

At the December 12 ECOFIN meeting, compromise was reached on the SSM (i.e., the texts of the ECB and EBA regulations). Pursuant to this, the ECB will be the ultimate supervisory authority for all euro-zone banks, however, practical supervision of less significant banks will be exercised by the national authorities. Significant banks subject to direct ECB supervision will be those:

- whose total assets exceed EUR 30 billion,
- whose ratio of total assets to their home country's GDP exceeds 20%, unless the value of total assets is below EUR 5 billion,
- those qualified by their national authorities as significant,
- the ECB may qualify a bank as significant based on its cross-border activities,
- those banks which have requested or received public financial assistance from the EFSF or the ESM[9],
- the three most significant banks of each euro-zone country.

Assigning the decision regarding macro-prudential resilience (originally an SSM competence), to national authorities is against the Single European Rule Book.

The implementation of the SSM was postponed to March 2014 or twelve months after the entry into force of the regulation, whichever be later. Member states agreed to finalise their proposals regarding the Bank Resolution and Deposit Guarantee Scheme Directives by June 2013.

2.4. *Blueprint for a deep and genuine European Monetary Union - creation of a common crisis resolution mechanism*

In its document titled *Blueprint for a deep and genuine European Monetary Union*, the European Commission reiterates its intention to propose a single resolution mechanism for member states participating in the banking union (SSM) once the proposals for a Bank Recovery and Resolution Directive (BRRD) and a Deposit Guarantee Scheme Directive have been adopted. This mechanism would be built around a separate European Resolution Authority, which is envisaged to be more efficient than a network of national resolution authorities.

The proposed Single Resolution Mechanism (SRM) would based on the following principles:

- As a result of strict common prudential rules and improved coordination of supervision within the Single Supervisory Mechanism, the need for resolution should be reduced to the minimum.
- Where intervention by the Single Resolution Mechanism is necessary, shareholders and creditors should bear the costs of resolution before any external funding is granted, in accordance with the proposed BRRD.

[9] European Financial Stability Facility, European Stability Mechanism,

- Any additional resources needed to finance the restructuring process should be provided by mechanisms funded by the banking sector, instead of using taxpayers' money.

The European legislators are looking into the possibility of creating the SRM through secondary law without amending the European Treaty (as is the case with the Single Supervisory Mechanism) .

3. EBA

3.1. EBA work programme 2013

The work programme defines the main objectives and corresponding priorities of the EBA for 2013. The fundamental objective for the EBA in the area of regulatory policy will be to play a central role in the development of the single rule book**,** with the aim to contribute to achieving **a** level playing field and to raise the quality of financial regulation and the overall functioning of the single market**.** The EBA's work in this area relates in particular to the CRD4/CRR legislative framework, including liquidity and remuneration, and the crisis recovery and resolution legislative framework. In its oversight activities, the EBA will focus on identifying, analysing and addressing key risks in the EU banking sector, including analysing the consistency of outcomes in risk weighted assets **(**RWAs**),** the sustainability of banks' business models and reviews of banks' asset quality, promoting supervisory cooperation and convergence and continuing its work in supervisory colleges to strengthen European supervision of cross-border banking groups. The EBA is committed to enhancing consumer protection and promoting transparency, simplicity and fairness for consumer financial products and services across the single market. Accordingly, it will focus its consumer protection activities on developing guidelines on responsible mortgage lending, and on arrears handling and forbearance in the mortgage market.

The EBA work programme specifies 282 tasks, including 118 Priority 1 tasks.

The proposed banking union is also reflected in the EBA's work programme for 2013, since it will call for an ever stronger commitment to a Single Rule Book and unified supervisory methodologies with a view to avoiding polarisation of the single market between the euro area and the rest of the EU.

3.2. Final report on the recapitalisation of European banks

In the summer of 2011, the EBA imposed a requirement for major European banks to raise their capital adequacy ratio to 9% by the end of June 2012. During the recapitalisation exercise, 27 banks that submitted capital plans have strengthened their capital position by EUR 116 billion. Overall, the exercise led to an increase of banks' capital positions of more than EUR 200 billion between December 2011 and June 2012**.** This was achieved mainly via retained earnings, new equity and liability management. Capital strengthening has not led directly to a significant reduction in lending into the real economy, a deleveraging process had already started before the capital exercise**.**
The EBA has asked banks to develop appropriate capital plans for CRD4/CRR implementation. These plans will be monitored by national supervisors in cooperation with the EBA and within colleges of supervisors**.** Dividend distribution and other variable payments will be constrained for banks that would not be able to respect their plans in normal time and under stressed conditions.

3.3. Assessment of SME proposals of the CRR/CRD4

In July 2011, the European Commission requested the EBA to analyse the possibilities for a reduction of the current risk weights for SMEs lending. Accordingly, the EBA analysed the a possible reduction of the risk weights by one third and the impacts of a possible increase from EUR 1 million to EUR 5 million in the regulatory threshold for SMEs and the introduction of the supporting factor (0.7619) proposed by the European Parliament. The results of the analysis and the EBAs comments were presented to the European Commission in September and published in October.

Based on the criteria of sensitivity, effectiveness and the overall consistency of the regulatory framework, the EBA does not support the reduction of the capital requirements for SME lending or the introduction of a supporting factor. Instead, the EBA proposes three possible solutions:

1.) Introduction of a temporary exemption for SMEs from the 2.5% conservation buffer .
2.) A regulatory measure to overcome cyclicality in the supply of finance for SMEs during periods of economic difficulty.
3.) Introduction of a supporting discount for SMEs. The advantage of this solution would be that it would be applied at the end of the process of capital calculation and thus not affect the risk weights. It would be subject to review and gradual reduction as SME lending grows.

As for increasing the threshold for SME lending, the EBA considers that a new definition of SME exposures would be required, by using the size of the firm as a criterion, instead of the size of the loans**.**.

The EBA points out that a reduction of the capital requirements for SME lending is not the best solution to promote SME lending: the European Commission's action plan for SMEs covers a wide range of initiatives and regulatory measures which would be far more effective in promoting SME lending, such as promoting venture capital, improving SME access to capital markets, promoting ratings for SMEs, enforcing late payment regulations or providing guarantees.

3.4. Revised liquidity and leverage ratio reporting requirements

Following the relevant consultations in June, the EBA published the revised Implementing Technical Standards (ITS) and supervisory reporting templates for liquidity and leverage ratio reporting. Since the CRR has not yet been adopted, these ITS are not final, however, they take account of the results of the consultations conducted in June. By publishing the ITS already in December, the EBA sought to promote the implementation process.

Extending its data collection for decision making, from 2013 the EBA will collect data on a quarterly basis for the calculation of the Liquidity Coverage Ratio LCR, the Net Stable Funding Ratio (NSFR) and the leverage ratio. Banks may participate in the exercise on a voluntary basis, however, the EBA's objective is that the European banking sector is properly represented and the diversity of the banking sectors in the various member states reflected in the exercise. The templates used for data collection are based on the Basel Committee's templates, adjusted to take account of European specifics.

As an addition to the package, the EBA will publish the Data Point Models for the liquidity and leverage ratio reports in the first quarter of 2013. The final ITS will be published once the CRR has been adopted. The final ITS are expected to only contain minor differences from the current versions. The EBA expects the first reports to be submitted in the first quarter of 2014.

3.5. Other publications

In addition to the above, in the last quarter of 2012 the EBA published the following documents in relation to prudential regulation:

Follow-up review of banks' transparency in the 2011 Pillar 3 reports,

Consultation on technical standards on cooperatives, mutuals, savings institutions and similar institutions,

Guidelines on the assessment of the suitability of members of the management body and key function holders,

Consultation paper on regulatory standards for prudential reporting,
Credit institutions register,
Opinion on the recommendations of the High-level Expert Group on reforming the structure of the EU banking sector.
Opinion in response to the consultation published by the European Commission regarding a possible framework for the recovery and resolution of non-bank financial institutions**.**

4. European Banking Federation - IBFed[10]

4.1. CRR/CRD4

In the context of the trilogue (European Commission, Council and Parliament), in November the EBF wrote a letter to the parties involved (the EU rapporteur and shadow rapporteurs, financial attachés and the Commissioner), presenting its position on the various issues. (According to information, the trilogue addresses 27 issues, issues outside this scope are not addressed).

Flexibility package

- The systemically important financial institutions (SIFI) surcharge appears to be untimely and inappropriate, given the economic crisis and the important intermediation role played by European banks. The finalisation of the FSB/Basel Committee recommendations should be awaited before prescribing a SIFI surcharge. The EBF suggests that the SIFI surcharge should not be included in CRD4.
- The SIFI surcharge and systemic risk buffer should not be additive.
- It is important to ensure consistency with future international agreements on SIFIs. The BCBS global systemically important banks (G-SIB) framework envisages an initial surcharge between 1% and 2.5% while the Commission's and Council's latest drafts do not set any upper limit.
- The EBF supports the Commission's initiative of limiting the criterion of cross-border activity to third countries for the purpose of identifying SIFIs. (This is in line with the principle of the single market).

SME lending

- The SME lending supporting factor is an important step forward. The supporting factor should be applied to a sufficiently wide scope of SMEs, i.e., to all those with a turnover of less than EUR 50 million, with no restriction to the exposure level. An exposure cap of EUR 1.5 million would be rather low notably in economies with bigger SMEs.
- If an exposure cap is maintained, it should be made clear that the supporting factor would be applied to the whole of the exposure up to the cap level. (For example, if the total exposure to a SME is of EUR

[10] 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)

2.4 million and the cap is set at EUR 2 million, then at least EUR 2 million should be subject to the supporting factor and only EUR 0.4 million would be assigned a regular risk weight).

The supporting discount proposed by the EBA could be workable as long as the capital relief for SMEs is equivalent to the one proposed in the supporting factor, i.e. neutralising the additional requirement due to the buffers of Basel III.

Liquidity ratio

The EBF suggested that the trilogue leave the details for the liquidity standard open to await the final Basel standard and assess the implementation status in other third countries. The EBA should start data collection and monitoring as planned.

The EBF gave comments on the treatment of individual retail and SME deposits larger than EUR 1 million, the eligibility of central bank credit lines, the inflow factor for customer loans with undefined maturities and the treatment of established operational deposits (deposits of customers with whom the bank has an established operational relationship).

The EBF proposes January 1, 2014 as an appropriate implementation date in respect of the liquidity reporting requirements. It is unreasonable to expect banks to design, develop and test systems solutions before the final technical standards and the final legal text of CRR/CRD 4 are available.

Prudential filters

The EBF has proposed amendments to Article 30 of CRR (enclosure 1) to maintain the current prudential filters at least until the accounting standard setters resolve on the treatment of the available-for-sale portfolio in the review of IFRS9 underway. The objective is to avoid the undesirable volatility in the capital requirement and the material impact on global financial stability that the removal of such filters would bring about until IFRS9 is put in place.

Trade finance

The EBF welcomes that trade finance is included in the debate, which is a sign of commitment to protecting the financing of the economy.

Credit valution adjustment (CVA)

Credit valuation adjustment is one of the most sensitive issues in CRR from the perspective of the impact on the real economy. The EBF strongly recommends the exemption of the CVA capital requirement for exposures to non-financial counterparties.

Deductions to capital

The EBF reiterates its objection to the proposal to fully deduct software from capital, as evidence supports its value even in cases of liquidation, and the prudential treatment in other jurisdictions is diametrically opposed. The level playing field with the U.S. remains a key point. The EBF urges EU policy makers to find a solution before closing the dossier or to mandate the EBA to conduct an international assessment and to issue guidelines on the treatment of software.

Basel III floor

In understanding that international policy makers broadly agree on the maintenance of the Basel 1 floor, the EBF proposes that in the calculation of the floor, the former Basel 1 rules of capital and risk weighted assets

should prevail for the sake of consistency and to allow institutions to avoid unnecessary IT development costs for a temporary measure.

Loss Given Default (LGD) floor

The EBF argues that the possibility to lift the LGD floor upon national discretion (above the current 10%) would unnecessarily distort the level playing field within the EU.

Exposures to the central governments or central banks denominated in the currency of any Member State

The treatment of exposures to the central governments or central banks denominated in the currency of any member state should be equivalent irrespective of the model used, be it internal risk based (IRB) or standardised.

Separation of roles

The separation of roles envisaged in Article 86-1(c) of CRD4 could be unnecessarily restrictive. The EBF suggests that competent authorities be allowed to judge the situation on a case-by-case basis.

Interplay with other regulatory proposals

The EBF is concerned about the interferences between CRR/CRD4 and the proposal for a Banking Union, as well as the *Liikanen* report on reforming the structure of the EU banking sector. In particular, concerns arise as to the potential conflict in the timelines for implementation. The determination of systemic buffers has to be made clear. The EBF fears that the combined effect of opinions and reviews of so many supervisory bodies (national authorities, the Commission, the single supervisor for the Eurozone (ECB), the ESRB and the EBA) could add too much complication to the process, leading to higher buffers in the EU than in other jurisdictions. The overall impact on the EU banking sector and the EU economy remains a concern and remains unassessed.

Implementation date

In a joint press release on November 9, the U.S. regulatory agencies announced the postponement of the implementation of Basel III, originally planned to be applied from January 1, 2013. As an explanation they said market players would not have had sufficient time to understand the new rules or make the necessary systems changes. At the same time, the U.S. regulatory agencies emphasized their commitment to the implementation of the Basel accord and - without giving a specific date - promised to work expeditiously to complete the rule-making process.
Following this announcement, the president of the EBF wrote a letter to the responsible EU officials, requesting the postponement of the enforcement of CRR/CRD4 to January 1, 2014 to level the competitive position of EU banks, as the market uncertainty over the implementation date hinders banks in planning their strategies on the funding as well as on the lending side.

Finally, proving the concerns, the capital requirements and liquidity standards were not adopted in 2012, the Parliamentary vote on CRD4/CRR was postponed to March 11-13, 2013. The trilogue continues in 2013. The Irish presidency has the following issues on its agenda:

- Flexibility package: the authority of the ECB, as the Single Supervisor, to determine national buffers (This contradicts the decision made in connection with the Banking Union!).

- Liquidity ratio (LCR): some MEPs still insist on setting stringent inflow and outflow factors whilst the Commission seems more inclined to make use of the full observation period.
- Remuneration: no agreement has been reached yet on the proportion of variable remuneration and the deferred portion.
- Credit valuation adjustment: the original stances of the Parliament (in favour of the exemption to non-financial counterparties) and the Council (for the exemption of sovereign ones) remain unchanged, while the Commission dislikes the idea of another departure from Basel III.

- SME lending: compromise has been reached on relaxing the capital requirements, but there is no written agreement on this yet.

4.2. EBF comments on the Liikanen report

- The EBF appreciates the thorough analysis conducted by the High Level Expert Group (HLEG). The analysis acknowledges that no particular business model was more or less vulnerable in the crisis, that the benefits of the universal banking model should be retained, that the single market should remain intact and that the regulatory reform agenda represents a substantive response to addressing the deficiencies that became apparent during the financial crisis.
- Given this analysis, the final recommendations of the HLEG calling for mandatory separation of proprietary trading activities and other significant trading activities over a certain threshold are open to legitimate challenge. The EBF contends that a compelling case for mandatory separation has not been made in the report.
- In addition, in the EBF's view, the recommendation for mandatory separation is very general in nature; it does not adequately address the riskiness of assets; it does not solve the issue of systemic risk; it has distortive effects upon bank functions of vital importance to customers and the European economy; it will impact negatively on banks' ability to lend to the economy; it will reduce diversification benefits of the universal banking model; it will reduce the competitiveness of the European financial sector compared to financial sectors not affected by this recommendation; and it will lead to a further fragmentation of the Single Market.
- Instead of the proposed mandatory separation, EBF supports the HLEG recommendation to further strengthen the use of Recovery and Resolution Plans (RRPs), as it fits better with the current regulatory reform agenda and can be incorporated with a considerably less distortive impact than mandatory separation.
- The effective use of RRPs must be viewed in the context of a well-functioning crisis management framework in concurrence with the BRRD proposal and should be based on an ongoing dialogue between the supervisor and the individual bank. The separation of certain activities in the RRP should be the last resort: the supervisor should not impose structural measures on banks that are going concern and banks should have legal recourse to such supervisory decisions.
- The HLEG does not address the potential economic consequences of implementing the proposed mandatory separation of trading activities. However, mandatory separation of trading activities would lead to higher costs that would hit bank customers in particular. Hence, the EBF calls for an impact assessment of any legislative proposals.
- The EBF is yet to be convinced of the use of a designated bail-in category as recommended by the HLEG against the proposition put forward in the BRRD proposal that a broad range of instruments should be eligible for bail-in.
- The EBF argues that the introduction of floors for risk weights and hence also the recommended floor for the trading book constitutes a significant threat to risk modelling and to the principle of calibrating capital requirements according to actual risks. The EBF is involved in an ongoing dialogue with policy-makers to improve the internal models of banks.

- With regard to the recommendation for an extra non-risk based capital buffer for the trading book on top of the risk-based requirements (Basel II.5 and Basel III), the EBF finds that any additional steps in this direction should await the finalisation of the review of the trading book and take into account the buffers already proposed in the CRD4/CRR. The same goes for the HLEG recommendation for introducing LTV/LTI caps for real estate related lending – CRD/CRR already gives national supervisors a number of tools to address macro prudential risks.

According to information received from the EBF, the HLEG's recommendations will be a priority on the European Commission's agenda in the first half of 2013, especially with regard to the separation of trading activities over a certain threshold, which will be analysed in detail. It is likely that a targeted consultation will be held in the spring on this issue. Accordingly, no legislative proposal is expected by then.

4.3. Developments regarding reporting

The European Central Bank has set up a working group to promote access to its database. Access will be provided to balance sheet data of banks, interest rates and securities market statistics.

The IBFed is preparing a working paper on ensuring the confidentiality of reports submitted to national supervisors. Since data exchange between supervisors is given increasing emphasis in supervisory cooperation, data confidentiality should be given increased attention. The IBFed's working document seeks to present not so much the current practice, but the future data processing requirements.

Central banks are collecting data on the 50 largest exposures from 28 globally systemically important banks. According to plans, the first reports should be submitted in March 2013.

In response to the requirements of the European Systemic Risk Board, the EBA plans to add five new reports to the set of FINREP templates. The new templates are related to the breakdown of assets and liabilities, breakdown by trading partner, collaterals underlying liabilities, renegotiated loans and the linking of prudential and accounting data.
The EBF expressed its objections to the fact that banks had not been consulted on the new templates and thus, the difficulties in generating the required data and potential duplications had not been taken into account. In their response, the regulators said that the proposed new templates would be submitted to public consultation and the introduction date of the new templates may be different from that of other elements of the technical standard.

The EBA plans to conduct an impact study on the proposed new supervisory reporting framework.