HUNGARIAN BANKING ASSOCIATION

REPORT

on Activities of the Hungarian Banking Association

3rd Quarter 2013

Budapest, October 31, 2013

Contents

1. EXECUTIVE SUMMARY 3

1.1. Operating environment, performance of the banking sector 3
1.2. International regulation 4

2. RETAIL LENDING 4

2.1. Tasks related to foreign currency-based residential mortgage loans 4
2.2. Consultation with FX debtor organisations 4
2.3. Demonstrations 5
2.4. Basic Payment Accounts, bank account switching 5
2.5. EU Mortgage Credit Directive 6

3. CORPORATE LENDING 6

3.1. Corporate lending performance 6
3.2. Funding for Growth Scheme Stage I 7

4. PAYMENTS 7

4.1. Consultation on the implementation of the Electronic Payments and Clearing System (EFER) 7
4.2. POS promotion project 8
4.3. Regulation of interbank interchange fees 8
4.4. ATM disaster recovery plans 8
4.5. Review of the EU Payments Services Directive 9

5. TAXATION, ACCOUNTING, REPORTING 9

5.1. Taxation issues 9
5.2. Proposal to ensure easier access to tax information for credit appraisal purposes 10
5.3. Bank accounting: Hungarian legislation – transition to IFRS 10
5.4. Reporting - CRR/CRD IV. 11

6. MNB – PSZÁF 11

6.1. MNB – PSZÁF merger 11
6.2. BUBOR reform 12

7. REGULATORY DEVELOPMENTS 12

7.1. Preparations for the new Civil Code 12
7.2. Review of the draft law on the drafting and amendment of certain financial laws 13
7.3. Proposed amendments to Act LVII of 1996 on the prohibition of unfair and restrictive market practices (Competition Act) and to certain provisions related to the Competition Authority 13
7.4. Proposal for an amendment to the Act on Stamp Duty 13

8. COMMUNICATIONS 13

***ANNEX* 15**

1. Executive Summary

1.1. Operating environment, performance of the banking sector

There was no positive change in the operating environment for banks compared to the previous quarter, despite the fact that the overall economic results were not negative, whether internationally or in Hungary. Although the international economy did not pick up in the first half – the EU economy, so important for the Hungary, stagnated, with slackened demand – the recession has ended in the EU. The international financial markets remained relatively calm, although there were some swings caused by the ECB's and the FED's expected decisions or the debate around the U.S. debt ceiling.

After a 0.5% drop in the first quarter, Hungary's GDP rose by 0.2% in the second quarter. The recession has officially ended. Inflation was positive, the MNB continued its rate-cutting cycle (reducing the base rate in several steps from 6.75% in September 2012 to 3.6% in September 2013). As a result of the low base rate, banks' deposit and lending rates continued to fall. The low base rate and the declining lending rates have thus far failed to result in a perceivable growth.

The banking sector continued to be characterised by a duality. Banks' capitalisation is strong and their liquidity is good, primarily due to the fact that parent banks have compensated the losses caused by the special taxes and other burdens through capital increases. At the same time, banks were unable to fulfil their fundamental economic role. The stock of corporate loans continued to drop, falling by 9.7% year on year as of end-2012, and this trend continued in the first eight months of 2013. Retail loans saw a similar negative trend, falling by 15.8% as of the end of 2012 and this trend failed to reverse as of August 2013.

The sector's profit after tax was negative, with a loss of HUF 243 billion in 2011 and HUF 164 billion in 2012. In Q3 2013, the sector's aggregate after-tax profit was barely HUF 23 billion. This practically means that invariably the banking sector is unprofitable. While the results of the individual banks show wide deviations, the sector is expected to remain in the red overall in 2013. These negative results are primarily due to the special taxes and burdens imposed on banks and the deterioration of the portfolio quality. At the end of 2012, 13.7% of all loans were over 90 days past due, 9.4% less than 90 days past due. As of August 2013, these ratios were 14.3% és 10% respectively, indicating a further deterioration in the loan portfolio.

As of the end of the first half of 2013, the loan-to-deposit ratio fell to 114%, mainly due to the withdrawal of funds by parent banks. Domestic savings and deposits are increasingly important factors. Corporate and retail deposits kept falling in 2012 and in the first eight months of 2013. Deposit interest rates today do not provide any real yields, high-yield government bonds pose serious competition to bank deposits. Bank deposits were adversely affected by the imposition of a 6% health care contribution on interest income in addition to the 16% interest tax.

Banks's results were further adversely affected by the increase of the Financial Transaction Levy, announced in September, imposing an additional HUF 75 billion additional payment obligation on banks. While previously only some of the banks passed on the levy to the customers, the increase in the levy rates has now appeared in the costs charged to customers by most of the banks, making banking more costly.

The MNB's Funding for Growth Programme and the launch of the second package of the programmed continued to be a priority in the sector's activities in the third quarter. The first package of the programme was well-received by banks, the refinancing facility was fully used. Based on the MNB's figures as of end-August, the ratio of new loans at the sector level was nearly 60%, half of which were investment loans, and slightly more than 40% of the loans were replacement loans.

1.2. International regulation

Global regulation in the third quarter continued to be focused on implementation of the reforms agreed by the G20 leaders. The international regulatory bodies, the Financial Stability Board and the Basel Committee on Banking Supervision give special emphasis to consistent and level-playing-field implementation of the Basel III capital and liquidity framework and to monitoring banks' readiness. Priorities include the tackling of IRB divergences, the finalisation of the regulation on leverage ratio, the enhancement of risk disclosure, the harmonisation of the treatment of non-performing loans, the finalisation of proposals for the regulation on shadow banking and the adoption and implementation of the framework for the recovery and resolution of financial infrastructures.

Currently, the most important regulatory endeavour of the EU is the creation of the banking union. With a view to establishing a Single Supervisory Mechanism (SSM), the European Parliament and the European Council adopted the regulation on the ECB and the relevant amendments to the EBA regulation. The SSM will take effect in November 2014, preparations are in progress. The launch of the SSM will be preceded by an assessment of banks directly supervised by the ECB. The European Commission submitted its proposal for a Single Resolution Mechanism and the EU rapporteur filed its draft report. The triloge on the proposed bank recovery and resolution framework (BRRD) continues. These latter two regulations are planned to take effect in January 2015. In August, the European Commission revised the rules for state aid to support banks, in line with the introduction of bail-in.

In addition to the banking union, the EU authorities are focused on consistent implementation of CRR/CRD IV and the creation of a detailed single rulebook for financial services. Other issues on the agenda include structural reform (the mandatory separation of certain activities) and the regulation of shadow banking activities and money market funds.

2. Retail lending

2.1. Tasks related to foreign currency-based residential mortgage loans

In the third quarter, a key task for the Association was to meet the governments' call to make the repayment amounts of foreign currency-based residential mortgage loans more favourable and to phase out these loans. The Association and the government agreed in four main points: FX borrowers should not be made better off than HUF borrowers, the burdens should be equitably shared between the three affected parties: banks, FX borrowers and the government; in any solution, the burdens on the economy and the banking sector should be distributed over a longer period of time. The government gave the Banking Association until November 1 to table a proposal or face a government solution.
With no response received to our proposals submitted in early September, we presented additional proposals to the Minister for National Economy in October.

2.2. Consultation with FX debtor organisations

The real or presumed interests of FX debtors are represented by a number of civil society organisations. To take account of the proposals of civil society organisations in the Association's proposals, the Association invited the most well-known of these organisations for a consultation. Seven organisations accepted our invitation. A pre-agreed aspect of the consultation was that the proposals should meet the conditions officially published by the government. Based on the discussion it was concluded that most of the invited organisations failed to make any substantive proposals and only formulated conditions, in many cases demanding that before any solution is agreed, banks should unconditionally commit to reducing the repayment amounts.

2.3. Demonstrations

Following the Supreme Court's verdict, postponed in June and then issued in July in an FX loan litigation, some groups presenting themselves as advocacy organisations for FX borrowers started to draw attention to themselves through rallies and actions involving the damaging of bank branches and intimidating bank employees. These incidents became regular from the second week of August, a fact largely contributed to by the perplexity of the police. By the autumn, the demonstrations were already directed at banks' CEOs and even the Prime Minister.
We called for the National Police Headquarters in several letters to take action, within the appropriate legal constraints, against these violent acts, causing banks damages, intimidating bank employees and disturbing public order.
From the end of August, increased cooperation was launched between banks' physical security heads and the Police to restrain the demonstrations and to investigate the motivations of the leaders and their mass base. It was established that these demonstrations are attended by a very small number of people (10 to 35), who, however, are aggressively drawing attention to themselves, in particular from the media. It was also revealed that the organisers of these demonstrations had previously acted as credit agents and had themselves borrowed large loans, providing real estates other than their homes as collaterals. Apart from the objective of applying political pressure as declared by the demonstrators, we could not rule out the presence of certain political powers behind these demonstration.

2.4. Basic Payment Accounts, bank account switching

In the first half of 2013, 30,000 new Basic Payment Accounts (BPAs) were opened, 10,000 more than in the first half of 2012. In terms of number of BPAs opened, Hungary is above the EU average.
Under the simplified bank account switching procedure introduced by our relevant self-regulation, 2,200 costumers initiated switching in the first half of the year, out of which 1,400 cases were successfully completed.
Although both self-regulations are based on EU initiatives, the EU authorities are dissatisfied with the EU-level results and have decided to propose statutory regulations on the above two issues (access to BPA and bank account switching) and on the comparability of bank accounts, instead of self-regulation. The European Banking Federation is active on these issues and we are trying to influence the contents of the proposed – and in some points controversial – legislation through them and through the Ministry for National Economy.

Another development that complicates the picture is the statement by some (government) politicians that two cash withdrawals per month up to the average wage (HUF 150,000) should be a basic consumer right and, therefore, provided by banks free of charge.
In addition to contravening the principle of a market economy, stipulated in the Fundamental Law (by not allowing even the recognition of actual costs), this proposal would incentivise cash payments, which would strengthen the black economy and discourage even those with bank accounts from using their accounts. In addition, this measure would be unnecessary, since according to the Labour Code, salary payments may not entail any charge for the employee; in other words, the charges are borne by the employer. Employers normally pay their employees a lump sum cost allowance, which

is a lower cost than that involved in paying salaries in cash (disbursement, processing, transportation, safekeeping, etc.).

2.5. EU Mortgage Credit Directive

The European Parliament has adopted the Directive on mortgage credits. The Directive is expected to take effect in January 2014 and member states will have two years to implement it.

The Directive is explicitly consumer protection-oriented and aimed to help the borrower in both the decision-making phase as well as during the contractual period. It regulates banks' tasks in virtually all phases of the lending process (such as providing mandatory contents for advertisements, requiring the provision of customers with a product comparison table) with a view to enabling the customer to make an informed decision. The Directive aims to provide the customer with continued support also after conclusion of the loan contract (such as the right to rescind the contract or the right to change currencies in the case of foreign currency loans).

Throughout the long drafting process of the Directive, industry associations (including the Hungarian Banking Association) have sought to ensure that consumer-protection aspects do not supress the aspects of implementability and banks' equitable interests. The industry has managed to ensure that:

- the legislation does not relieve the consumer from the responsibility for the decision (there will be no requirement for banks to provide advisory services, act in the "best interest" of the customer),
- the bank will not have to automatically reject the applicant in case of a negative creditworthiness assessment. It will have the space to consider other aspects, while on the other hand, it will not be required to lend even if the creditworthiness assessment is positive.

The industry's efforts to reduce the scope of information to be provided to the customer to a reasonable level (for example, in advertisements) were less successful.

A major advantage of the Directive is that it is aligned in both spirit and structure with the Consumer Credit Directive (CCD), adopted a few years ago. Accordingly, the ensuing tasks may be fairly similar to those currently carried out by banks on a day-to-day basis. Another advantage is that most member states (including Hungary) have extended the implementation of the Consumer Credit Directive to mortgage credits, consequently, the new legislation will only require the introduction of a limited number of new rules.

The Association provided members with detailed information on the new Directive.

3. Corporate lending

3.1. Corporate lending performance

According to MNB statistics, corporate lending started to rebound in Central and Eastern Europe already in 2012. Hungary is the only country where the negative trend seen since 2008 has failed to be reversed. The stock of corporate loans fell by HUF 105 billion, or 6.4% in the second quarter of 2013. In contrast to the first quarter, the decline came from long-term loans in the second quarter. Lending conditions were somewhat relaxed compared to the previous quarter, but the constraints to credit supply remained tight. The stock of foreign currency loans fell again, by the same volume as HUF loans.

In June, the impact of the Funding for Growth Scheme was only felt in the number of corporate loans disbursed, with the scheme being mostly used for loan replacement at that time. The impact of the scheme on the volume of loans is not yet felt and will depend on whether the volume of new loans has exceeded the volume of maturing loans.

As a slightly positive development, the MNB's rate-cutting cycle is increasingly reflected in the pricing of corporate loans: the average interest rate on loans with a minimum maturity of five years is 6.39%. The interest rates for Euro-denominated loans rose and so did the premiums. Another positive development is that the ratio of non-performing corporate loans decreased from 18.3% to 17%. Deleveraging continued: the loan-to-deposit ratio was 114% at the end of the first half of 2013. Accordingly, liquidity in the banking sector has grown.

3.2. Funding for Growth Scheme Stage I

On June 1, 2013, the MNB launched its Funding for Growth Scheme to stimulate SME lending. Under Pillar I and Pillar II of the scheme, the MNB granted refinancing loans with zero percent interest and a maximum maturity of ten years. The total facility was HUF 750 billion, the application period was from June 1 to August 31. Financing banks could relend the central bank funds at a maximum interest margin of 2.5%.

The first pillar of the scheme was aimed to reduce the financing costs of businesses with existing loans and to facilitate the implementation of investment projects hindered by high financing costs.

The second pillar of the scheme was aimed to reduce foreign currency-based loans in the SME loan portfolio.

Under the third pillar of the scheme, the MNB introduced FX swap and currency interest rate swap (CIRS) tenders with eight different maturities to add new euro liquidity. As was the case with FX conversion under Pillar II, customers are required to reduce their external funds by the same rate as that of the foreign currency acquired by them under the Pillar III. In this way, Hungary's external debt is reduced. The FX-swap tenders had maturities of 5 weeks, 13 weeks (3 months) and 26 weeks (6 months), the maturities of currency interest rate swaps were 78, 91, 104, 117 and 130 weeks (18, 21, 24, 27 and 30 months).

According to MNB statistics, as of mid-August banks concluded contracts with SME customers to a total value of HUF 124 billion. Based on August figures, the share of new loans in total loans was nearly 60 percent, half of which were investment loans, and slightly more than 40 percent of the loans granted were replacement loans. The relatively high percentage of new loans is attributable to the increase in demand for loans due to the attractive interest rates. The loan objectives vary depending on bank size. New loans granted by large banks under Pillar I included less new investment loans, nearly half of the loans were replacement loans. The share of replacement loans in all loans granted by small and medium sized banks was nearly the same, while the share of investment loans in new loans was higher. In contrast, in the case of savings cooperatives, more than half of the loans granted were investment loans, replacement loans made up less than a quarter of all loans granted.

The average maturity for new investment loans was 7.9 years, that for working capital loans 5.1 years. In the case of replacement loans, the maturities increased compared to the replaced loans: the average maturity of loans replacing investment loans was 7.3 years, that of loans replacing working capital loans was 5.9 years.

The total value of contracts concluded under Pillar II was more than HUF 60 billion. Nearly 80 percent of these were loans replacing euro loans and 20 percent replacing Swiss franc loans. The average maturity for investment loans was 7.7 years, that for working capital loans was 5.7 years. In the case of investment loans, the average maturity compared to the original investment loan is shorter, the average maturity for working capital loans is unchanged.

4. Payments

4.1. Consultation on the implementation of the Electronic Payments and Clearing System (EFER)

After a successful test period, the government agency responsible for the Electronic Payment and Clearing System (EFER) requested the Association to organise a consultation to present to members the expected benefits of the project and the conditions for banks to join the system.

In meeting this request, the Association invited members' heads of the areas affected (e-Channels, IT Development and Payments). At the meeting, held with high attendance by member banks, leaders of the project outlined the benefits of the system for banks' customers and for government agencies. (A main objective of the EFER project is to radically reduce the number of credit transfers made to wrong account numbers in payments to government agencies, by putting in place a home banking system). They also presented the benefits and conditions for banks to join the system as well as the related IT development challenges. Upon the questions raised by banks, a number of business, legal and IT-related issues were clarified. The leader of the project indicated that all documents required for joining the system are available on the agency's website and the agency is open to answering any questions, whether directly, or through the Association. According to our information, two banks are expected to join the system still in this year, and an additional two in the first quarter of 2014.

4.2. POS promotion project

After more than a year of preparations, a project to promote card acceptance was launched in August. Under this, POS terminals are deployed as a test at merchant locations in Fejér County. The project is implemented at the MNB's initiative and financed by Mastercard. Cooperating in the project are the Hungarian Banking Association and six financial service providers providing card acceptance services (Budapest Bank, Erste Bank, K&H Bank, OTP Bank, SIX Payment Services and Takarékbank). There is an allocation of EUR 1 million made available for infrastructure development purposes under the project. Implemented in cooperation with market players, this pilot project is aimed to create the conditions for payment by bank card at merchants and catering facilities currently not accepting bank cards, to thereby allow customers to choose between cash and card payments. The project, running until the end of this year, may provide useful experience for promoting card acceptance on a national level. At the Association's request, an objective of the project is to identify merchant motivation factors (a debated issue). Initial feedback after the first few weeks of the project shows moderate interest from merchants. During preparations for the project, the Association specifically drew the attention of the organisers to the importance of high-standard compliance with competition rules.

4.3. Regulation of interbank interchange fees

On September 23, 2013, the Parliament passed the Act regulating interchange fees. This caps the interbank interchange fees for debit and credit cards at two and three percent, respectively, effective January 1, 2014. These rates are consistent with the European Commission's legislative proposal, which, however, would have provided for an implementation period of two years. At the same time, according to reports, the European Commission is not going to present the draft legislation to the European Parliament in this parliamentary cycle. Thus, Hungary will certainly be a forerunner as a live test environment for the EU regulatory concept.

At around the same time (after two years of national consultations) the Polish Parliament, too, adopted a regulation setting the domestic interbank interchange fees at 0.5%.

In line with its professional duty, the Association several times drew attention to the risks in reducing interbank interchange fees (see our Q1 2013 report). The Association also proposed the highest possible degree of alignment of the legislation with the EU proposals. We also emphasised the importance of gradual implementation and the need for wide consultations between the government and market players to ensure that the legislation is well-founded and the expected market impacts are properly assessed.

4.4. ATM disaster recovery plans

MNB organised a consultation on business continuity plans for a mass ATM failure. The central bank considers that the outsourcing by many banks of their ATM cash management to CIT companies is a

significant risk, since a potential breakdown of the CIT company's services might jeopardise the satisfaction of customers' cash needs. The MNB proposes that banks should either arrange for the filling up of the ATMs at their branches by the branch staff, or equip their branches with cash recycling machines.
Banks voiced their reservations as follows:

- it was the MNB decree allowing only mechanically processed banknotes to be used in ATMs that has prompted many banks to outsource the filling up of their ATMs.
- In case of a breakdown of the CIT company's services, neither the branch, nor the cash recycling machines would have enough cash,
- If in this case the central bank arranged for the supply of major branches with cash, banks' tills would be able to serve all customers (including those of other banks) through the POS terminals.

The representatives from the MNB took note of the banks' position, while pointing out that in certain cases (for example, where the filling up of the ATMs and the management of the ATMs are done by two different CIT companies, or by two separate units of a CIT company), there may be disturbances in the ATMs' cash replenishment. In this case, a disaster recovery plan is indispensable. They promised to discuss with us the relevant regulatory proposal.

4.5. Review of the EU Payments Services Directive

The Payments Working Group reviewed the draft of the proposed revision of the EU Directive. Based on this review, we sent our comments to the European Banking Federation as follows:

- we proposed that due to their different natures, bank cards and other electronic payment instruments should be treated separately,
- in the case of bank cards, the limit on the cardholder's liability before notification of the incident (EUR 150) should be retained, while the setting of this limit for electronic payment instruments (online payments, mobile banking) should be a national discretion, based the local circumstances,
- instead of the current, extremely flexible, rules, the Directive should set out the prudent behavioural standards expected of customers in relation to electronic payment instruments,
- in the case of lost/stolen electronic payment instruments, the customer should only be entitled to financial compensation if he has reported the incident also to the police, we proposed that in case the new payment services to be introduced by the Directive (account information services, payment initiation services) are provided by a third party, the Directive should regulate the relationship between the bank managing the account, the customer and the third party providing these services in a clear-cut manner.

5. Taxation, accounting, reporting

5.1. Taxation issues

The taxation working group drafted a number of proposals regarding the tax law package to be presented to Parliament in the autumn.

A major issue is the classification of SMEs: monitoring the customer's compliance with the SME status criteria on a continuous basis is unmanageable. In our view, the problem should be solved by changing the relevant tax regulations. During the summer, we initiated with the Tax Authority and the Ministry for National Economy that the Tax Authority should publish a list of businesses classified as SMEs, based on the classification to be indicated by businesses' in their tax returns. The are several SME financing programmes running and it would be helpful if an official SME list were made available from a common official database. Regrettably, our proposal was not supported, essentially because the data are not verified and there is no legal ground for such disclosure. Hence, we drafted a text proposal to require businesses to state their SME status in their tax returns. We also submitted a proposal to adjust the provision related to SMEs in the Bank Tax Act. Also, we proposed the simplification of the process for obtaining tax certificates for credit appraisal purposes.

The new EU capital requirements entail the need to address the issue of general risk provisions. We submitted a proposal for transferring the previously tax-exempt provisions to retained earnings and requested the adjustment of the accounting rules accordingly.

Other issues addressed by the Taxation Working Group included the extension of the data contents of the Financial Transaction Levy tax return form, payer's duties related to personal income tax, issues related to stamp duties, VAT self-audit, and some other issues causing banking technical problems. In several cases, we requested rulings from the Ministry for National Economy.

5.2. Proposal to ensure easier access to tax information for credit appraisal purposes

At the Association's initiative, a consultation was launched with the Tax Authority to review the possibilities for ensuring easier access by banks to information related to customers' tax compliance. At the meeting held with the involvement of competent officers from member banks, the Tax Authority pointed out that they only provide tax information to fellow authorities and the current legal environment does not support an automated data flow to the private sector. What the legislation does allow is that the customer can retrieve his tax data from the Authority, which he then may pass on electronically or by ordinary mail or in person to the bank.
This process, especially with regard to the verification of the tax certificates received, is extremely expensive and time-consuming. In view of the fact that since July 1, 2013, legislation requires the Tax Authority to manage its foreclosure measures directly electronically with the banks, we proposed that the Authority should make it possible for banks to access the tax certificates on the customer's tax compliance through this channel, of course, subject to the customer's consent. We submitted to the Ministry for National Economy a specific text proposal to amend the relevant regulation and requested the Tax Authority to support the proposal.

5.3. Bank accounting: Hungarian legislation – transition to IFRS

Review of the programme launched by the Ministry for National Economy for transition to IFRS continued in September. Representatives of the auditing profession presented the findings of a research conducted on 20 countries (including 16 CEE). In the countries analysed, the biggest problem was identified as the lack of sufficient knowledge by accountants and auditors of IFRS. The harmonisation of tax laws, considered as a major aspect in Hungary, was less of an obstacle in other countries. The key success factors identified included, inter alia, targeted continuing training for accountants and authority staff and the availability of high-quality local translation of IFRS. Costs, and the availability of sufficient implementation time were also identified as essential factors.

A valid conclusion of the study is that the financial sector should be given special attention, given its specifics and its relevant statutory obligations (compliance with prudential requirements, reporting obligations, monetary and other statistical aspects, etc.).

In turn, the benefits of IFRS include better consistency of the accounting methodology, the reduction of administration and the comparability of business information across Europe and globally.

The next step in the preparatory stage (managed by the Ministry for National Economy and involving representatives from the auditing profession, listed companies and representatives from the financial sector and the accounting profession) will be to identify the companies that are in the most advanced stage of readiness for transition to the IFRS and those for whom IFRS should be made optional or mandatory.

The Association anticipates that Hungarian banks will be among the first to be affected by the transition to IFRS. During the discussions we emphasised our position as follows:
- mandatory application at the solo level should only be imposed after due adjustments to the related regulations, and with an implementation period of at least two years,
- those ready should be allowed to opt for IFRS for fiscal year 2015,
- the content requirements for Notes to the Balance Sheet should be reduced for small banks,
- SMEs involved in the consolidation should be allowed to apply IFRS at the solo level on a voluntary basis,
- for other financial institutions equivalent to credit institutions (guarantee organisations), the use of IFRS should be optional.

5.4. Reporting - CRR/CRD IV.

The CRR/CRD IV framework, applicable to European banks effective January 1, 2014, was promulgated in the summer, but the relevant technical implementation standards (reporting templates and guides) were not published as of the end of September.
The implementation of the CRR/CRDIV framework will bring major changes to the bank reporting system and will require significant IT developments. The Association is consulting on a continuous basis with the regulators and keeps members informed on the developments. Banks have also indicated the need for closer cooperation. However, progress has been perceivably hindered by the delay in decision-making on issues subject to national discretion, due to the cessation of PSZÁF.
The first reports according to the new reporting requirements are to be submitted in May 2014 for the period ending March 31, 2014. Distant as this deadline may seem, one should be mindful of the fact these changes involve not only the redesign of the templates, including additional rows or columns, but also, the adoption of a different approach. Adding to this is the fact a certain group of large banks (listed and systemically important banks, 12 in number) will be required to switch from Hungarian Accounting Standards to IFRS. Listed banks have prepared their annual financial statements according to IFRS on a mandatory basis since 2005. However, the new COREP, and the FINREP framework entering into force from 2014 require different and more detailed data contents than the current financial statements.
According to a survey conducted by us, less than half of the banks have the necessary systems in place to support COREP and FINREP reporting according to IFRS from 2014. The majority of banks need to implement major system development projects, given that the required data can only be generated in a non-automatic manner, with major efforts and a lot of manual additions.
The delay in decision-making, caused by the delay in European legislation and by the PSZÁF-MNB merger generates impatience among the reporting community. The relevant EU Implementation Technical Standards (ITSs) are expected to be published in October and we have an oral promise from the central bank for a consultation to be held for banks following the publication of the ITS.
Also in relation to reporting, we participated in the review of the proposed 2014 reporting requirements related to the MNB’s monetary authority role.

6. MNB – PSZÁF

6.1. MNB – PSZÁF merger

The fifth amendment to the Fundamental Law has assigned the supervision of the financial intermediary system to the MNB. Accordingly, the new MNB Act has also assigned this function to

the central bank. The new legislation has dissolved PSZÁF effective October 1, and the change in the organisation exercising the supervisory function has been updated to the legal system by a separate law, called the MNB omnibus legislation. We gave special attention to this legislation, given that, by definition, the change in the supervisory authority directly affects banks. The MNB Governor has issued the new bylaws of the central bank. According to these, a newly appointed MNB deputy governor will be responsible for financial supervision and consumer protection.
The change does not affect the existing recommendations issued by PSZÁF and in terms of contents, the provisions contained in the existing PSZÁF decrees will remain in force until the end of the year.
PSZÁF's staff members have been transferred to the MNB, with the provision that their employment may be terminated after six months without giving any reason. This uncertainty has harmed earlier well-functioning working relationships and currently, it is difficult to obtain rulings on the various legal interpretation issues.

In connection with the new MNB Act, the MNB initiated high-level consultations, to be held at a later, unspecified, date. In this regard, and with a view to consulting with the MNB on technical issues left open by the new MNB Act, the Association's Board at its July meeting decided to set up a working group on the issue. Although set up in July, with the central bank failing to respond to the Association's requests for consultation, the working group commenced operations as late as October 2. At its meeting of October 2, the working group identified and prioritised open issues related to the merger of supervisory functions into the MNB. A summary letter on these issues was sent to the MNB Governor on October 10.

Treasury and market risk specialists from member banks held a meeting in September to discuss current issue related to liquidity. In the wake of this meeting we wrote a letter to the MNB Deputy Governor responsible for monetary policy, requesting the MNB's position regarding the application of liquidity rules of the CRR and the recognition as central bank eligible collaterals of state debt or state-guaranteed debt to banks, in particular, former central bank eligible municipal bonds involved in the municipal debt consolidation. We also requested the MNB's support for the recognition of these instruments as liquid assets under the CRR.

6.2. BUBOR reform

The current sponsor of the BUBOR rate-setting process (the Hungarian Forex Association) circulated to the other three organisations involved (the MNB, PSZÁF and the Association) the draft agreement for cooperation in the redesign of the rate-setting process in July, followed by a modified draft in September. As a new element, this included the redesign of other rate-setting processes managed by the Hungarian Forex Association (BIRS, HUFONIA SWAP Index). The organisational and financing frameworks were set out in the draft agreement in accordance with our proposals. Review of the proposal is still in process.

7. Regulatory developments

7.1. Preparations for the new Civil Code

In preparing for the new Civil Code, coming into effect on March 15, 2014, we continued our seminar series for banks' legal counsels. In October, a presentation and consultation on the Legal Entities chapter of the Civil Code was held by Dr Gábor Gadó, with 50 participants attending. We plan to hold a similar seminar before the end of the year.
We are continuously monitoring the status of laws related to the entry into force of the new Civil Code. In relation to the collateral register, we wrote a letter to Tibor Navracsics, Minister of Administration and Justice.

7.2. Review of the draft law on the drafting and amendment of certain financial laws

We reviewed the draft law on the drafting and amendment of certain financial laws in several rounds. In the wake of the new EU capital requirements and liquidity framework, the Ministry for National Economy drafted a **new Banking Act (**a part of the new EU requirements are stipulated in a directly applicable EU Regulation, while the changes in the EU Directive need to be transposed into Hungarian legislation). The Banking Act has been amended several times over the past 17 years, hence, a new regulation in a consolidated structure has become necessary. In addition to the Banking Act, the law package contains a separate law on certain payments services. This regulates the institutional framework and activities of payment institutions, electronic money issuers and voucher issuers and sets out rules for external payments services provided by the Post Office and the Hungarian State Treasury. The law package also contains a draft law amending certain economic laws, including the Bankruptcy Act, the Act of Voluntary Pension Funds, the Act on Judicial Foreclosure, the Act on Building Societies, the Capital Market Act, the Insurance Act, the Act on Investment Firms, the Act on MNB and a number of other laws. The law package extends the definition of residential mortgage loans to include replacement loans and provides that the HUF-equivalent of foreign currency-denominated loans and their repayment amounts should be calculated at the bank's midrate.
In view of its diverse contents and its importance, the law package is being reviewed by several working groups of the Association.

7.3. Proposed amendments to Act LVII of 1996 on the prohibition of unfair and restrictive market practices (Competition Act) and to certain provisions related to the Competition Authority

This draft legislation affects the procedure related to the investigation of interlocks, the limitation of the right to view documents and the provisions on the organisation and legal status of the Competition Authority. Also, it allows the Competition Authority to conduct market research that does not involve mandatory reporting requirements. The provisions related to misleading advertisement will also change. During the review of the proposed legislation, we concluded that the proposal was a professional and well-considered work, therefore, we only made some minor comments, to make the provisions of the legislation more specific. The proposal has changed significantly in the meantime due to subsequent Parliamentary amendment proposals.

7.4. Proposal for an amendment to the Act on Stamp Duty

A 2013 amendment to the Banking Act has extended the timeframe for banks to alienate their acquired real estates to <u>six years, instead of three years</u>. (This alienation requirement applies to real estates acquired by banks based on a loan-real estate swap as per Section 83(4) of the Banking Act (4) or based on Section 56 (2) of Act XLIX of 1991 on Bankruptcy and Liquidation Proceedings, or based on Act LIII of 1994 of 1994 on Judicial Foreclosure).
This amendment of the alienation deadline has not been followed up in the Act on Stamp Duties. Therefore, we proposed that the preferential stamp duty should be extended to the extended period, through an appropriate amendment to the Act on Stamp Duties.

8. Communications

The Association conducted extensive communications in the third quarter, with regular media appearances aimed at addressing current issues affecting the banking sector. In Q3, we had 1360 appearances in the media. As was the case in the previous periods, the most frequent were our appearances in the online media, in 760 instances, followed by the print media, in 350 instances, and the electronic media (TV, radio), in 240 instances. Altogether, we had more than 780 appearances and mentions in the media in 2013.

Main issues addressed in our communications in Q3 included current issues related to FX loans, the process and results of negotiations with the government, solution proposals drafted by the Working Group on FX loans, the August increase of the Financial Transaction Levy, including its expected impacts and the relevant preparations made by banks, and the reduction of interbank interchange fees, including the expected impacts. As for the most important issues, the Association expressed its views through press releases and the Association's leaders gave interviews and participated in debate programmes on the main issues.

ANNEX

INTERNATIONAL DEVELOPMENTS: REGULATION, SUPERVISION – EUROPEAN BANKING FEDERATION

I. Global regulation

I.1 Financial Stability Board (FSB) report on financial regulatory reforms progress

Ahead of the G20 St. Petersburg summit in September, the FSB Chair Mark Carney delivered a progress report on the implementation of financial regulatory reforms. Taking stock of the accomplishments since 2010, he pointed out that as a result of strengthened capital requirements, banks' capitalisation (in particular that of systemically important banks) has improved substantially and significant progress has been made in addressing the too-big-to-fail problem, reforming shadow banking and making derivatives markets safer.

As for what remains to be done, he emphasised the need for consistent and full implementation of Basel III framework. The strengthening of capital has been uneven, some banks still require significant capital injection. The IRB risk models that banks use to calculate their capital needs show worryingly large differences. This must be addressed to restore the confidence of depositors, investors, clients and authorities in banks' balance sheets. The remaining parts of Basel III should be implemented, including the leverage ratio to be agreed by the Basel Committee in early 2014. Financial institutions should improve their risk disclosures and accounting standard-setters should agree on a new converged standard for loan impairment.

In addressing the too-big-to-fail problem, the FSB Chair highlighted the progress made in identifying systemically important firms in different sectors, imposing higher capital requirements and more intensive supervision on these institutions, and reforming national resolution regimes. At the same time, he pointed out the need for national authorities to develop the necessary cross-border agreements to enable resolution plans to be put into effect. Alongside those actions, the FSB will make proposals on the total loss absorbing capacity that systemically important banks should have in resolution, so that they are resolvable in a crisis without tax payer support.

In 2014, the FSB will finalise policies to mitigate the systemic risks of the repo and securities lending market (which are key funding sources for shadow banks) and the Basel Committee will finalise proposals to address the risks from banks' interactions with shadow banks. Authorities should promptly introduce requirements for the reporting of all derivatives trades to trade repositories, adopt rules for central clearing and trading on organised platforms, and adopt resolution regimes for financial market infrastructures such as central counterparties.

At their meeting in St. Petersburg, the G20 leaders agreed that regulators and jurisdictions may diverge in the details. What is essential is that the agreed standards should have the same impacts and lead to the same results (outcomes-based approach).

Here, it is to be mentioned that the FSB and the International Monetary operate a joint project to eliminate data gaps and ensure information exchange and information sharing.

I.2 Report to the G20 group on monitoring implementation of Basel III regulatory reforms

In August, the Basel Committee on Banking Supervision (BCBS[1]) and the Financial Stability Board prepared a report for the G20 leaders on implementation of the Basel III regulatory reforms**.** In October, this report was updated according to the status as of September 30. Progress in implementation of Basel II, Basel 2.5 and Basel III in the various jurisdictions was assessed for the fifth time within the framework of the Regulatory Consistency Assessment Programme (RCAP). The report reveals that Argentina, Russia and the United States are yet to fully implement Basel II. The U.S. has issued final regulations on Basel II, however, its largest banks are still on parallel run for implementing the advanced approaches. The other two jurisdictions, Argentina and Russia, are in the process of completing Basel II implementation. Some of the Basel 2.5 rules will only take effect in 2014 in the United States. Out of the 27 jurisdictions that comprise the Basel Committee, the final set of Basel III based capital regulations has been issued in 25 (of which 11 have gone into effect). In addition, a number of members have begun to move towards introducing regulations for the liquidity and leverage ratios as well as the requirements that apply to firms designated as global systemically important banks.
The report also assesses progress in banks' calculations of risk-weighted assets.

I.3 BCBS Basel III monitoring exercise

After April and September 2012 and March 2013, the Basel Committee published the results of its latest review of the implications of the Basel III standards for banks in September. 223 banks participated in the study, including 101 Group 1 banks and 122 Group 2 banks (Group 1 banks are banks with Tier 1 capital in excess of EUR 3 billion and internationally active, all other banks are considered Group 2 banks). The results of the monitoring exercise assume that the final Basel III package has been fully implemented, based on data as of December 31, 2012, that is, they do not take account of the transitional arrangements set out in the Basel III framework, or assumptions about bank profitability or behavioural responses, such as changes in bank capital or balance sheet composition. For that reason, the results of the study are not comparable to industry estimates. Data as of December 31, 2012 show that shortfalls in the risk-based capital of large internationally active banks continue to shrink. The aggregate shortfall of Common Equity Tier 1 (CET1) capital with respect to the 4.5% minimum has narrowed to EUR 2.2 billion, which is EUR 1.5 billion lower than on June 30, 2012. At the CET1 target level of 7 % (plus the surcharges on G-SIBs as applicable), the aggregate CET1 shortfall for Group 1 banks is EUR 115 billion, which is EUR 82.9 billion lower than previously. As a point of reference, the sum of after-tax profits prior to distributions across the same sample of Group 1 banks during 2012 was EUR 419.4 billion. The capital shortfall for Group 2 banks included in the sample is estimated at EUR 11.4 billion for the CET1 minimum of 4.5% and EUR 25.6 billion for a CET1 target level of 7%. While this represents an increase compared to the previous period, this is mainly due to some Group 2 banks that are included for the first time. The sum of Group 2 bank after-tax profits prior to distributions in 2012 was EUR 29.5 billion. The average CET1 capital ratios under the Basel III framework across the same sample of banks are 9.2% for Group 1 banks and 8.6% for Group 2 banks.
The short-term Liquidity Coverage Ratio (LCR), to be phased-in gradually from January 1, 2015, was measured for the first time according to the revised standard of January 13. The weighted average LCR for the Group 1 bank sample was 119%. For Group 2 banks, the average LCR was 126%. This

[1] Basel Committee on Banking Supervision. The Basel Committee is the primary global standard-setter for the prudential regulation of banks and provides a forum for cooperation on banking supervisory matters. Its members include the heads of the supervisory authorities of Argentina, Australia, Belgium, Brazil, Canada, China, France, Germany, Hong Kong, India, Indonesia, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, Russia, Saudi Arabia, Singapore, South Africa, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States.

indicates that banks included in the sample have no problems in meeting the LCR requirement (which has been significantly eased since 2010).

I.4 BCBS consultative report on LCR disclosure standards

In July, the Basel Committee issued a draft of the LCR common disclosure template for internationally active banks. National authorities may apply the LCR disclosure requirements to other banks as well. The data must be calculated on a consolidated basis and published from January 2015, with the same frequency as the bank's financial statements (typically quarterly or semi-annually). The proposed standard provides a table that sets out an explanation of each line of the common template, with references to the relevant paragraph/s of the Basel III LCR rules text issued in January. It also provides instructions for the calculation. In addition to the LCR, the Basel Committee gives special emphasis to the disclosure of other liquidity related information that management monitors and provides guidance for the contents of such information, as well.

I.5 BCBS discussion paper - The regulatory framework: balancing risk sensitivity, simplicity and comparability

In June 2012, the Basel Committee commissioned a task force to review the Basel capital framework to identify opportunities to remove undue complexity within the framework and improve the comparability of its outcomes. The task force was asked to consider whether the current capital adequacy framework strikes an appropriate balance between simplicity and risk sensitivity. Based on the report of the task force, the Basel Committee issued a discussion paper, outlining the potential benefits and costs that arise from a more risk sensitive methodology. The Committee emphasises that the issues raised require careful consideration before any changes to the capital framework are proposed and the Committee's goal at this stage is to solicit comments and feedback from interested stakeholders. The Committee emphasises its view that full, timely and consistent implementation of Basel III is itself an important step in improving the consistency and common understanding of bank regulation globally.
The discussion paper defines the concepts of simplicity, comparability and risk sensitiveness. It presents the evolution and objectives of the risk-based capital adequacy framework. It provides potential ideas to improve simplicity and risk sensitivity and finally, it puts five specific questions for feedback.

The International Banking Federation in general supports efforts to simplify the capital framework, as long as the effectiveness of internal risk models and the strength of the overall regulatory framework are not compromised. The IBFed believes that internal models provide more accurate and refined measures of risk than simpler, standardised models and their complexity reflects the complexity of the financial markets. It emphasises that any increased complexity must be justified by corresponding risk measurement benefits. The IBFed points out that comparability among banks could be enhanced by a well thought-out disclosure framework. In its response, the IBFed stresses that banks calculating their capital requirements by using the IRB approach should not be required to disclose the results of the standardised approach, and such results should remain confidential supervisory information.

In its response to the discussion paper, the European Banking Federation emphasises that European banks have devoted large resources to using the internal rating based approaches. The EBF does not share the presumption that an overhaul to the capital adequacy framework is required, increasing regulatory convergence would suffice.

I.6 Other BCBS documents

In addition to the above, the following documents published by the Basel Committee in the third quarter should be highlighted:

- Global systemically important banks: Updated assessment methodology and higher loss absorbency requirement
- Capital requirements for banks' equity investments in funds
- Regulatory consistency assessment programme: – Analysis of risk-weighted assets for credit risk in the banking book
- Mortgage insurance: market structure, underwriting cycle and policy implications (final document)
- Margin requirements for non-centrally cleared counterparties (final document).

II. EU regulation

II.1 Single Supervisory Mechanism (SSM)

Following adoption by the European Parliament on September 12, 2013, the European Council adopted the SSM framework with some delay, on October 15, 2013. The new regulation on the ECB and the amendment to the regulation on the European Banking Authority (EBA) will take effect five days and one day respectively after their publication in the EU Official Journal. The SSM will start operations one year after publication in the Official Journal, in November 2014. The ECB's monetary and supervisory functions will be strictly separated to avoid potential conflicts of interest. A supervisory board responsible for the preparation of supervisory tasks will be set up within the ECB. The board's draft decisions will be deemed adopted unless rejected by the ECB governing council. Non-eurozone countries participating in the SSM will have full and equal voting rights on the supervisory board. The EBA regulation has been amended to ensure that the countries participating in the SSM do not unduly dominate the EBA's board of supervisors. The EBA will retain its competence for further developing the single rulebook.

In its press release, the European Banking Federation welcomed the adoption of the SSM framework as a true milestone in the banking union project.

Five task forces have been set up, led by Ignazio Angeloni, the ECB Director responsible for general financial stability, to prepare the SSM, with the following responsibilities:

- identifying those banks that will come under direct supervision by the ECB (mapping),
- drafting the legal framework (cooperation between the ECB and National Competent Authorities (NCAs).
- developing the supervisory models (methodologies to apply to all participating member states),
- defining the reporting requirements,
- reviewing banks' balance sheet (to promote growth and restore confidence).

The review of banks' balance sheets will only take place after the SSM Supervisory Board has been set up.

II.2 ECB comprehensive assessment of banks in advance of its supevisory role

The European Central Bank is launching a comprehensive assessment of banks in preparation for its full supervisory role under the Single Supervisory Mechanism. The assessment includes the following elements:

- supervisory risk assessment, including an asset quality review (AQR),
- balance sheet assessment (BSA)
- stress test.

The supervisory risk assessment and the balance sheet assessment will take place in the first half of 2014. The stress test will commence in May or June and take four months. The stress test will be conducted in close cooperation with the EBA, although the relationship between the EBA's regular annual stress tests and the ECB's one-time stress test is not fully clear yet. During the assessment, the EBA proposals for non-performing loans and the results of its assessment of risk weights will be taken into account.

The EBA proposes that national supervisors should also carry out an asset quality review for banks in their jurisdictions.

In relation to the AQR, the EBF wrote a letter to the ECB deputy governor responsible for preparing the review, drawing attention to the procedural, reputational, and financial stability risks that all those involved should be aware of. The letter stresses that the AQR should be based on equal, transparent and pre-planned methodology. In order to avoid misinterpretations, the results of the AQR and those of the EBA stress test (which follows a completely different concept) should be published at the same time. However, the publication of the results should not coincide with the presentation of banks' 2013 year-end indices. It is important that the ECB involve the banks affected at an early stage in the planning, scheduling, implementation, evaluation and communications of the AQR.

II.3 Bank Recovery and Resolution Directive (BRRD)

The trilogue on the BRRD continued in September. The most debated issues (where political agreement appears to be the most difficult) include the following:

- Home/host decisions: the European Parliament considers that mandatory EBA mediation should only be required in the resolution stage, while the Council says it should be required in all stages of the process (recovery and resolution plans, prevention, early intervention, resolution). It is also debated whether the EBA regulatory technical standards would properly substitute mandatory mediation by the EBA.
- Bail-in: while the European Parliament seemingly argues for the widest possible scope of bail-inable instruments, it also supports a wide range of exceptions, which might spoil the efficiency of bail-in.
- Depositor preference: beyond insured deposits, the Council wants to reduce this preference to SME deposits.
- The use of resolution funds to avoid the bailing-in of deposits. / The use Deposit guarantee Schemes during resolution.
- Resolution funds: The EP would like a target level of 1.5%, the Council wants a target level of 0.8%. The proposed target level, including Deposit Guarantee Scheme funds are 3% and 1.3%, respectively.
- State intervention: the EP continues to support the inclusion of stabilisation instruments in the bail-in.

Additional debated issues include the appointment of resolution authorities, the scope of application of the BRRD, cooperation with third countries and the composition of the Minimum Requirement for Own Funds and Eligible Liabilities (MREL). The European Commission rejected the Lithuanian proposal to exclude deposits from the calculation of MREL, saying that banks with significant deposits would need to search for other financing sources to be able to comply.

Beyond the BRRD, there are two other issues being discussed in parallel: the Single Resolution Mechanism and the target level for Deposit Guarantee Schemes.

In September, the EBF wrote a letter to participants in the trilogue (the European Parliament, the European Council and the European Commission), to converge views. In this, the EBF proposed:

- strengthening of the confidentiality of Recovery and Resolution Plans (RRPs),
- the full harmonisation of bail-inable instruments to ensure a level playing field,
- limiting the target levels for resolution funds and Deposit Guarantee Schemes,
- allowing flexibility in setting the desirable level of MREL – depending on the business model and the crisis resolution strategy (single or multiple points of intervention).

II.4 ECON[2] preliminary report on the Single Resolution Mechanism (SRM)

On July 10, 2013, the European Parliament's Committee on Economic and Monetary Affairs (ECON) published its proposal for a Single Resolution Mechanism[3]. The Committee would like to the Council to agree on the proposal before the end of this year and the European Parliament to adopt it before the European Parliamentary elections next spring. This would allow the enactment of the Regulation on the SRM concurrently with the Bank Recovery and Resolution Directive in 2015.

In October, the EP rapporteur, Elisa Ferreira, published her report on the proposed Single Resolution Mechanism. The report points out that the SRM is an integral part of the Single Supervisory Mechanism and the latter is inconceivable through purely national resolution interventions. In addition, the rapporteur supports the proposal to establish a common Deposit Guarantee Scheme (in view of the political realities, this is not contained in the Committee's proposal). For the credibility of the SRM, the rapporteur proposes establishing a common financial backstop, for instance, in the form of a public loan facility preferably through a European community instrument, until the Single Resolution Fund is built up, in order to protect depositors during resolution. The loan should be repaid by the Resolution Fund by a set deadline. Uncovered deposits would also be protected, since the Resolution Fund should be used before deposits start to be bailed in. Contributions to the Resolution Fund should take account of the degree of risk incurred by the bank. According to the rapporteur's amendment proposals, the resolution process would be preceded by a communication from the ECB. Resolution decisions should always follow a recommendation from the Single Resolution Board (for legal reasons, the decision power of the European Commission as the Resolution Authority would actually be formal). The appointment of the Executive Director and Deputy Executive Director of the Single Resolution Board should be conducted with the involvement of the European Parliament. The rapporteur did not make amendment proposals to those sections of the proposed SRM regulations which are interrelated with the provisions of the BRRD currently subject to trilogue discussions.

The ECON is scheduled to discuss and vote on the amendment proposals on November 14 and November 25, respectively. This will be followed by discussions between the European Parliament and the Council. The Council's experts are in the process of analysing whether the proposed solution is legally sound (compliant with the EU Treaty).

[2] See details in our Q2 report
[3] See details in our Q1 report.

According to press reports, member states are divided over the proposed financial backstop (potentially, access to the European Stability Mechanism). South-European member states, led by France, Italy and Spain would like the ESM (created to provide financial aid to the eurozone governments) to be available for bank bail-out, while Finland, Germany and the Netherlands would make the use of the ESM subject to certain conditions, to avoid bearing the costs.

In its position on the SRM, the European Banking Federation supports the concept of banking union and specifies the key conditions that are indispensable for the introduction of a single revolution mechanism: the SSM and the BRRD should be finalised and operational before implementing the SRM. A key precondition for the creation of the SRM is that it should not be burdened with legacy costs, legacy issues should be addressed nationally before banks can enter the SRM. The Single Resolution Board should be independent and accountable and there should be a clear separation of competencies between supervisors and the Board.

The EBF believes that the principal tool for absorbing losses is bail-in and not the SRF, therefore, the SRF target level should be lower than that proposed.
Members of the EBF are supportive of the creation of a Single Resolution Fund, but they consider that it can only be feasible in the long-term.

II.5 European Commission communication on the application of state aid rules after August 1, 2013.

In August, the European Commission published a revised version of its state aid rules to support banks. Pursuant to these:

1. Shareholders and junior creditors will be required to contribute as a first resort, before banks can ask for public funding. Junior creditors will be treated uniformly at the EU level, banks in stronger member states will not enjoy the advantages of lower funding costs arising from implicit state guarantees.
2. No state aid may be granted until agreement on burden sharing is reached and the resolution plan is approved by the Commission. (The experience of Spain has proven that the decision-making process has accelerated.)
3. Aided banks must set strict executive pay limits.

II.6 European Commission communication on shadow banking and proposal for the regulation of Money Market Funds (MMFs)

The European Commission’s communication, consistent with the FSB proposals, reviews the measures taken since the publication of the Green Paper on Shadow Banking in March 2012 and sets out potential next steps. The first step is a proposal for a regulation on Money Market Funds, aiming to strengthen the quality and liquidity of the asset portfolios held by MMFs, for MMFs to withstand redemption pressure in times of stress. According to the proposal, MMFs should hold at least 10% of their assets in instruments that mature within a day and an additional 20% within a week. The exposure to a single issuer is limited to 5%. To ensure stability, MMFs must hold a certain set capital buffer.
In addition to the MMFs regulation, the Commission gives special emphasis to improving the transparency of the shadow banking sector and the collection of detailed, reliable and comprehensive data on the sector. Additional measures include the regulation of securities lending and repurchase agreements and the regulation of the relationship between banks and the shadow banking sector.

III. European Banking Authority (EBA)

III. 1 EBA recommendation on the preservation of Core tier 1 capital

Following the promulgation of the Capital Requirements Directive in June, the EBA issued a Recommendation on the preservation of Core Tier 1 capital during the transitional period until the CRR/CRDIV framework is fully implemented on January 1, 2019. The Recommendation replaces the EBA recapitalisation Recommendation of December 2011 and applies to the same banks[4]. The Recommendation asks competent authorities to ensure that banks maintain a capital floor in terms of nominal amount which corresponds to the amount of capital required to be in place by June 30, 2012. In case banks fall below this nominal amount, they are expected to produce credible plans to restore their capital base. Exceptions may only be granted in specific circumstances, on a case by case basis. Exceptions can be granted by national authorities, in consultation with the EBA, if a bank is undergoing a specific restructuring or a de-risking programme or if a bank's capital levels are deemed to already exceed the CET1 requirements under fully implemented CRD/CRR rules. The EBA Chair, Andrea Enria, emphasised that *preserving capital in European banks is essential for maintaining the flow of lending to the real economy.*

Banks should submit their capital plans and monitoring templates to their national authorities by November 29, 2013.

III.2 ESA Joint Committee second report on the vulnerabilities of the EU financial system (cross-sectoral risks)

In August, the Joint Committee of the European Supervisory Authorities published its second report on vulnerabilities of the EU financial system. The Joint Committee points out that although important policy milestones have been reached, the key risks identified in the previous report remain. The weak macro-economic outlook continues to challenge the financial position of banks, insurers and investors and their profitability and asset quality continues to deteriorate. There is a clear need for continued de-risking across the EU banking sector, which is likely to manifest in changing business models and more bank resolutions. The macro-economic downturn has necessitated the lowering of interest rates and the expansion of the range of monetary operations. The protracted low interest-rate environment may lead to reduced profitability of European banks, the increased volatility of long-term interest rates and the risk of sharp interest rate increases is difficult for banks to hedge. The higher present value of long-term liabilities generates incentives for a search-for-yield behaviour by institutional investors.

The increased concentration in domestic markets and a fragmented European financial sector has continued. There is a clear scale-back on cross-border lending into economies experiencing sovereign stress or recession. Firms face increasingly different credit supply and pricing conditions according to their domicile and irrespective of their own profitability and risk.

The reliance on collateral, and especially, high quality assets such as governments bonds leads to rising concerns about potential collateral shortages. Collateral transformations, and in particular a potential lack of transparency stemming from those, are likely to increase the risks of interconnectedness and pro-cyclical effects.

The loss of confidence in balance sheet valuations, risk disclosures and financial benchmarks continues to have serious consequences. Cyber attacks on the Internet and mobile services of various banks in April and June have highlighted the operational and general risks in electronic banking. The resolution and recapitalisation of Cyprus banks, involving bail-in of deposits in excess of the EUR 100,000 deposit guarantee limit, has raised concerns about the risk of bail-in in future bank

[4] In Hungary, the Recommendation affects OTP Bank.

resolutions, although these have been addressed in part by agreement on a framework for Bank Recovery and Resolution (BRRD).

III.3 Documents published by the EBA in the third quarter

The EBA published the following main draft technical standards in the third quarter:

- Draft Regulatory Technical Standards for credit valuation adjustment risk,
- Draft Implementing Technical Standards on passport notifications,
- Draft Implementing Technical Standards on supervisory disclosure,
- Draft Regulatory Technical Standards on prudent valuation,
- Draft Implementing Technical Standards on capital requirements for Central Counterparties,
- Draft Regulatory Technical Standards on own funds requirements for investment firms,
- Draft Technical Regulatory Standards on close correspondence between the value of an institution's covered bonds and the value of the institution's assets,
- Draft Regulatory Technical Standards related to the specific risk of debt instruments in the trading book,
- Draft Regulatory Technical Standards on the method for the identification of the geographical location of the relevant credit exposures.

In early October, the EBA announced an extension of the deadlines for submission to the European Commission of six technical standards.

In addition to the above, the EBA published the following documents:

- Final Draft Regulatory Technical Standards on own funds and credit risk adjustments,
- Final Draft Implementing Technical Standards on supervisory reporting,
- Draft guidelines relating to retail deposits subject to higher outflows for the purposes of liquidity reporting,
- Discussion paper on unrealised gains measured at fair value,
- Second interim report on the consistency of risk-weighted assets in the banking books of EU banks,
- Report on the Basel III monitoring exercise assuming a full implementation of the Basel III framework as of December 31, 2012.

  Those interested may put their questions regarding a Single Rulebook (CRR/CRD IV and the related technical standards) on the EBA website. The EBA aims to answer the questions within two months.

IV. European Banking Federation (EBF)

IV.1 EBF response to the European Commission consultation on reforming the structure of the EU banking sector

The EBF welcomed the Commission's intention to conduct a complete impact assessment of the baseline scenario by taking into account the various national proposals (UK, Germany, France, Belgium). Meanwhile, it does not support either of the nine options outlined by the Commission, citing that all nine of them provide for mandatory separation, which would harm the universal banking model, the real economy and consumer interests. Instead, the EBF proposes an approach where the definition of high risk trading activities is based on the real level of risk in the trading book and not on accounting categories. It would favour a targeted approach, with the supervisor deciding

– on an individual bank basis and based on the RRP - on how the bank's high risk activities should be handled. Separation should be a last resort tool.

According to the EBF's information, the results of the impact assessment will be presented in October to the review body, followed by the inter-services debate of the Commission's proposal. Accordingly, the Commission proposal for structural reforms is expected to be published somewhat later than previously indicated, in late November or early December. It is also unknown at this point whether the Commission is going to present a regulatory proposal or only a recommendation.

IV.2 Letter to the European Commission on the EBA draft Implementing Technical Standards on supervisory reporting requirements

The European Banking Authority submitted its draft Implementing Technical Standards (ITS) on supervisory reporting for approval by the Commission. This ITS provides requirements for reporting own funds, financial information, mortgage credit losses, large exposures, leverage ratio and liquidity ratios. However, certain provisions of the ITS are inconsistent with or go beyond the CRR. For example:

- The EBA has no mandate to impose reporting requirements for exposures larger than EUR 300 million, this requirement should be omitted.
- The requirement regarding the Basel I floor is inconsistent with the CRR, hence, it has no legal ground.
- CRR Article 99 (5) mandates the EBA to develop common formats and IT solutions for EU supervisory reporting. In contrast, the EBA gives discretion to the competent authority, which contravenes the Single European Rulebook.

The EBF draws the Commission's attention to information deficiencies in the area of supervisory reporting. In developing the reporting requirements the EBA (and the ESRB) failed to consult with the industry, therefore, an EU-level forum should be created for exchange of views on the contents and implementation of regulatory reporting requirements.

IV.3 Letter to the ECB on Pillar 3

The EBF in principle supports the ECB proposal to eliminate redundancies and inconsistencies between supervisory reporting and disclosure requirements. It welcomes the European Systemic Risk Board's intention to seek a global solution and does not want to pre-empt such a solution. An important priority for EBF is how to make the co-relations between risk, regulatory and accounting data/reports more intelligible and more transparent through appropriate analysis. At the same time, the EBF cautions regarding the standardised reporting templates, given that without appropriate international harmonisation of the terminology, contents and accounting rules, the standardisation of formats and template can only be apparent and not real.
Disclosure requirements in Europe apply to all institutions, not just to capital market entrants.
During harmonisation, it is unwarranted to impose on them IFRS reporting burdens that are not required at the national level.

IV.4 EBF response to the consultation on revised Basel III leverage ratio framework and disclosure requirements

The EBF's key points are as follows:

- The EBF supports the view of the BCBS that the leverage ratio should remain a simple backstop measure that complements the risk-based capital framework for banks.

- The EBF considers it positive that the BCBS intends to achieve a uniform and consistently defined measure by seeking convergence in the treatment of assets and liabilities offsetting across accounting regimes in order to ensure an international level playing field. This, however, would have unintended consequences resulting in an Exposure Measure that is excessively inflated and too punitive for banks.
- Therefore, the EBF suggests that the BCBS adjust the proposed rules for the Exposure Measure to retain the leverage ratio as a backstop measure. This should be done by allowing for the incorporation of on balance sheet netting.
- The EBF is especially concerned about the proposed treatment of Securities Financing Transactions (SFT) exposures and derivatives. The main issues are: the gross measure of SFTs, the de-recognition of collateral and the notional treatment of written credit derivatives. Those measures would disproportionately increase the capital required to sustain essential banking activities and would create unintended effects on the real economy.
- The EBF is concerned that the proposed leverage ratio contradicts other newly implemented regulatory reforms such as the liquidity coverage ratio (LCR) and OTC derivatives reform. It is contradictory to ask banks to build up regulatory enforced buffers of high quality liquid assets through the LCR and punish this through the leverage ratio. EBF therefore proposes to exclude cash and LCR level 1 assets from the leverage ratio.
- The proposed 100% Credit Conversion Factor (CCF) for trade and export finance would be detrimental to such activities. Instead, the EBF proposes a CCF of 20 %.
- The EBF encourages the BCBS to make full use of the transition period and to postpone the disclosure date until the leverage ratio has been finally calibrated. The leverage ratio should not be recalibrated before it has been decided how to measure total assets under the leverage ratio. In addition, the leverage ratio should be introduced at a consolidated level only.

IV.5 EBF responses to other EBF consultation papers

In the third quarter, the EBF commented on the following EBA consultation papers:

- Draft Regulatory Technical Standards on the determination of the overall exposure to a client or a group of connected clients,
- Draft Regulatory Technical Standards on own funds (Part 3)
- Draft Regulatory Technical Standards specifying the range of scenarios to be used in recovery plans
- Draft Implementing Technical Standards on additional liquidity monitoring metrics,
- Draft Regulatory and Implementing Technical Standards on securitisation retention,
- Draft Regulatory and Implementing Technical Standards on passport notifications,
- Draft Regulatory Technical Standards on additional liquidity outflows corresponding to collateral needs resulting from the impact of an adverse market scenario,
- Draft Regulatory Technical Standards on institution-specific prudential requirements.