HUNGARIAN BANKING ASSOCIATION

REPORT

on Activities of the Hungarian Banking Association

4th Quarter 2013

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I. Executive summary

As far as the macroeconomic conditions are concerned, as a positive thing, there were no major external shocks and money market conditions remained favourable in the fourth quarter, as was the case throughout the year. The slow pick-up continued in the leading European economies. The U.S. debt-ceiling debate was solved, the European Central Bank and the FED – in contrast to the expectations – continued its asset purchase programme, although the latter announced the tapering of the programme.

Hungary's GDP grew by 1.8% in Q3 year on year, projecting a GDP growth exceeding 1% on an annual basis. Inflation fell to an all-time low of 1.7%, although core inflation did not yet hit the 3% target set by the MNB. The MNB continued its rate reduction cycle, although at a slowing pace (the base rate as of January 2014 is 2.85%).

The banking sector continued to be characterised by a duality. While banks' capitalisation is strong and liquidity at the sector level is good, profitability is low, the sector is expected to have remained in the red in 2013. The stock of retail loans declined throughout the year, falling by 6% over year-end 2012. Due to the Funding for Growth Programme, the stock of corporate loans has not decreased, while the portfolio quality continued to deteriorate. The low profitability, low creditworthy loan demand and constant regulatory stress, mainly due to government measures, do not help banks in fulfilling their role of stimulating the real economy in the medium-term.

At the same time, undoubtedly, there were some government measures that can be considered as favourable for the sector. One of these was the launch of the second stage of the MNB Funding for Growth Scheme. The allocation for Stage II of the Scheme is HUF 500 billion, which may be increased by the Monetary Council up to HUF 2,000 billion. Under the Scheme, the MNB makes available refinancing with zero percent interest. Financing banks can relend the central bank funds at a maximum interest margin of 2.5%, in the form of loans or leasing facilities with a maximum maturity of 10 years. 90% of the allocation is for new loans. In the municipal segment, the now comprehensive consolidation provides security for banks, while the relaxation of the eligibility criteria is beneficial for fx debtors as well as for the banks.

A another positive fact for the economy and the banking sector is that, contrary to the government's September ultimatum, the prompt conversion of fx loans into HUF, a measure that would have unforeseeable consequences, was not imposed. As a major development, the Supreme Court – despite overheated expectations – adopted a sober legal uniformity decision, strengthening legal certainty. At the same time, consumer-oriented provisions of the new Banking Act, including the extension of the definition of home loans, provide better conditions for a wide range of retail customers.

In prudential regulation, the implementation of the EU Capital Requirements Directive (CRR), taking effect in January 2014, and the new Banking Act, transposing the EU Capital Requirements Directive (CRD IV) into Hungarian law will be a major challenge for the sector. The transition is made difficult by the entry into force of the new Civil Code on March 15, 2014. The implementation of the new Civil Code will involve a learning process for banks' legal staff and the adjustment of operations to the new requirements. Another major change is the implementation of the Act on collateral register. Other areas, such as payments, will also require operational changes.

An important change in banks' day-to-day operations was the merger of PSZÁF into the MNB. The merger, decided by legislation on September 16, was smoothly implemented as of October 1.

In payments, the raise of the Financial Transaction Levy, the imposition of the two free cash withdrawals option and the regulation of interbank interchange fees are causing banks losses. The POS terminal deployment project initiated by the MNB to promote bank card acceptance imposed substantial tasks on participating banks, while the results fell short of the MNB's expectations.

Demonstrations by radical fx debtor groups continued in the fourth quarter. As a new element, “chanting” demonstrations appeared. At the beginning of 2014 there was a bombing attack on a bank branch, drawing media attention. We have developed close cooperation with the National Police Headquarters in the handling and investigation of these atrocities as well as in other areas. The Association’s advocacy and communications activities in the fourth quarter included negotiations with the government and a consultation with fx debtors and civil society organisations representing them. Major events included the meeting of the Visegrád countries in Budapest, Association staff visits to member banks in the provinces and technical forums organised or sponsored by the Association (new Civil Code, tax law changes).

In global regulation, at its meeting in Moscow on November 8, the Financial Stability Board (FSB) discussed vulnerabilities affecting the global financial system and reviewed work plans to complete core financial reforms in 2014. In addition to financial reforms, key issues addressed by the FSB included the issues of more effective risk management, shadow banking monitoring, methodology for the identification of global systemically important financial institutions and the updated list of global systemically important banks and insurance companies.

Under its Regulatory Consistency Assessment Programme, the Basel Committee on Banking Supervision reviewed the timely adoption of Basel III standards and assessed the consistency and completeness of the adopted standards, including the significance of any deviations in the regulatory framework. The second consultative document on the fundamental review of capital requirements for the trading book and the second consultative document on revisions to the securitisation framework were also important parts of the BCBS’s regulatory programme.

In December, the U.S. regulatory agencies adopted final rules to implement the Volcker Rule, providing for the separation of trading activities. Work on structural reforms in the EU is in the concept development stage, the actual proposal is expected to be issued in early 2014. Significant progress was made in the process of adoption of the Bank Recovery and Regulatory Directive (BRRD) and the Deposit Guarantee Schemes Directive (DGSD) and in the creation of the banking union (Single Supervisory Mechanism – SSM) and the Single Resolution Mechanism (SRM). The relevant pieces of legislation, along with the Mortgage Credit Directive, are expected to be adopted before the EU Parliamentary elections in May.
The development and implementation of detailed rules and technical standards for the CRR/CRD IV imposes significant burdens on the European Banking Authority and well as on banks, not to mention the comprehensive assessment exercise (supervisory risk assessment, asset quality review) to be launched by the ECB in February 14, followed by a stress test in the second half of 2014. This tight schedule has required, and will require, extensive lobbying by the European Banking Federation and its members.

II. Macroeconomic environment, performance of the banking sector

There was no perceivable improvement in the operating environment for banks compared to the previous quarter, notwithstanding the fact that the slow pick-up continued in the leading EU economies as well as in Hungary. There were no major shocks in the international money markets and no change in the European Central Bank's exchange rate policy and asset purchase programme. The U.S. debt-ceiling debate was solved. The FED announced the tapering of liquidity, but this will be spread out over time and carried out in several steps.

The Hungarian economy saw a surprising 1.8% growth year on year in Q3, projecting an annual GDP growth rate of more than 1% in 2013. As a positive development, in addition to exports, domestic demand, rising moderately, also contributed to this growth, together with the increase in investments, which grew by more than 10% as of September year on year.

Due to one-time effects (primarily, the government's utility cost cutting measures), inflation dropped to all-time low by the end of the year, bringing down the annual inflation rate to 1.7%. Core inflation net of one-time effects improved, too, although it is still above the 3% medium-term target envisaged by the MNB. Good inflation data and the relatively stable HUF exchange rate encouraged the MNB to continue its rate-cutting cycle, reducing the base rate to below 3% by the end of the year. (With the January rate cut, the base rate is now 2.85%.). In the wake of the decreasing base rate, the HUF interbank benchmark rates and banks' HUF deposit and lending rates decreased further.

The banking sector continued to be characterised by a duality. Banks' capitalisation is strong, with a capital adequacy ratio above 17%. Liquidity at the sector level is good, although with large differences at the individual banks' level. The stock of loans continues to exceed that of deposits. The banking system is able to meet the account and cash turnover needs, that is, it is capable of fulfilling its fundamental short-term economic functions. At the same time, the continuing low profitability due to government measures, the low creditworthy loan demand and the constant regulatory stress do no help banks in fulfilling their role of stimulating real economic growth.

The stock of **corporate loans** (both HUF and foreign currency) kept falling in the first half of the year. The stock of HUF loans saw a one-time rise in Q3, as a result of the MNB's Funding for Growth Scheme, then stagnated in Q4, according to data as of end-November. With an average 1% decrease in the HUF exchange rate, the volume of foreign currency loans slightly decreased.

The stock of **retail loans** declined throughout the year, according to end-November data, falling by 6% over year-end 2012.

The sector's profit after tax was barely HUF 51 billion as of the end of the third quarter. While the results of the individual banks show wide deviations, the sector is expected to have remained in the red overall in 2013. These negative results are primarily due to the special taxes, the increase in the Financial Transaction Levy from August, other burdens imposed on banks and the deterioration of the portfolio quality. The ratio of under and over 90 days **past due loans** grew from 9.4% and 13.8%, respectively, in 2012, to 9.7% and 14.5%, respectively, as of the **end of September 2013**. In retail mortgage loans, as a negative process, while the stock of past due loans remained relatively constant (33%-34% of the portfolio), the share of over 90 days past due loans rose compared to those under 90 days (16% vs. 17.1% in 2012, 18.6% vs. 14.8% in 2013).

The **loan-to-deposit ratio** of credit institutions fell by another percentage point, from 114% in Q2 to 113% as of end-November, with the drop in retail loans partly offset by the increase in corporate loans due to the MNB Funding for Growth Scheme. The stock of deposits grew slightly, by 0.18%, according to end-November data. This growth mainly came from a significant increase in corporate deposits, while retail deposits continued to erode, a negative process, mainly attributable to the low

interest rate environment and the crowding out effect of government debt financing, creating in an unlevel playing field. The withdrawal of foreign funding continued in 2013. The withdrawal of funds by parent banks was less significant, the decrease was mainly due to a drastic fall in foreign deposits (-18.7%), a negative trend somewhat offset by the issue of foreign currency bonds abroad by state-owned specialised credit institutions in the autumn.

III. Corporate lending

MNB statistics reveal that, except for Hungary, corporate lending started to rebound in Central and Eastern Europe already in 2012. The negative trend seen since in 2008 reversed in Hungary, too, in the third quarter of 2013, as compared to the second quarter.
The stock of corporate loans grew by HUF 130 billion, reducing the year-on-year decline from 6.4% in the second quarter to 3.5% in the third quarter. The increase came from new loans granted under the Funding for Growth Scheme, which also facilitated the extension of loan period and a shift in denominations towards HUF. The increase in the stock of loans is the combined result of a HUF 290 billion increase in long-term loans and a HUF 160 billion decrease in short-term loans. The share of HUF loans in total loans rose from 40% in Q3 to 48% in Q4. Lending conditions were somewhat relaxed compared to the previous quarter, but the constraints to credit supply remained tight.

Also as a 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 fell to 5.39% by November. 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% in the second quarter. Liquidity in the banking sector has grown too, according to the decreasing loan to deposit ratio.

Funding For Growth Scheme Stage II

With the success of Stage I of the Scheme, on September 11, 2013 the Monetary Council decided to continue the programme. The allocation for Stage II is HUF 500 billion, which may be increased by the Monetary Council up to HUF 2,000 billion.

In Stage II, the MNB continues to make available refinancing with zero percent interest. Financing banks can relend the central bank funds at a maximum interest margin of 2.5%, in the form of loans or leasing facilities with a maximum maturity of 10 years. Stage II of the Scheme was introduced on October 1, 2013 and will last until end-2014. 90% of the total scheme allocation is for new loans under Pillar I, 10% is for replacement loans under Pillar II of the scheme. As opposed to Stage I, allocations under Stage II are awarded on a first-come-first-served basis. The upper limit, separately applied to HUF loans and loans replacing FX loans has been raised from the current HUF 3 billion to HUF 10 billion. To achieve the goals under the first pillar of the scheme, the scope of use of SME loans has been reduced: in the case of investment loans, only projects closely related to the applicant's business activities can be financed under the scheme. The second pillar of the scheme is aimed to reduce foreign currency-based loans in the SME loan portfolio and to mitigate businesses' financing costs related to HUF loans or financial leasing aimed to prefinance EU grants. 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.

Municipal finance

The government recast the laws regulating the day-to-day operations of municipalities and the provisions required for the performance of their tasks. In addition, the framework for their financing was also changed. As a major step, the government sought to consolidate those debts required by municipalities to ensure their day-to-day operations and of implementation development projects previously not funded by the state.

To achieve this, the state provided a one-time non-refundable aid to county municipalities (HUF 197,6 billion) in 2011 and then to municipalities with less than 5,000 inhabitants and the multi-purpose micro-regional associations of these municipalities in 2012, as a repayment support for their debts to financial institutions. In 2013, the government partly assumed the debts of municipalities with more than 5,000 inhabitants (HUF 610.3 billion).

In continuation of the programme, under Act CCXXX of 2013, the government is assuming municipalities' and their micro-regional associations' debts to financial institutions outstanding as of December 31, 2013.

The consolidation extends to the full debt (capital, delinquent capital) and the related charges (interest, late interest, commitment fee, handling fee) as at February 24, 2018. Pursuant to the 2014 Budget Act, the state may carry out the assumption of certain debt elements by granting a one-time support for minor debts not exceeding HUF 200 million, or CHF 815,000, or EUR 660,000. In this way, the technique for the assumption of minor loan debts can be simplified.

In the case of municipalities where bankruptcy procedures are in process as of December 31, 2013, the debts will be consolidated within 60 days from the closure of the bankruptcy procedure, under a separate process.

The Association reviewed and commented on the draft legislation and, following the enactment of the legislation, submitted to the Ministry for National Economy proposals for the proposed guide describing the schedule of the debt consolidation and for the reporting forms. Banks, by making special efforts, duly met their reporting obligations by the statutory deadline of January 15, 2014.

IV. Retail lending

According to the MNB's November report on Trends in Lending: „Loans outstanding continued to decline in the household segment. In Q3, loans outstanding fell by around HUF 100 billion, corresponding to a 5.2 per cent annual decline. The decline in the outstanding amount was attributable to the reduction of foreign currency loans, while forint-denominated loans increased during the quarter. The volume of new loans continued to increase compared to the historic low seen at the beginning of the year. In the case of unsecured consumer loans, credit conditions continued to ease, while banks reported unchanged conditions on housing loans. The APR on actual transactions fell to 9.3 per cent in the case of housing loans, and to 11.5 per cent in the case of home equity loans, parallel with the cuts in central bank policy rate. However, the interest rate spread on housing loans is still extremely high in a regional comparison". This interest rate spread also reflects the high rate of non-performing and 90-day past due loans.

Development and submission of an FX debtor rescue package to the Ministry for National Economy

In September, the government gave banks an ultimatum to develop and present solutions for amending foreign currency-denominated loan contracts in a manner favourable for the customers. Without any specific statutory obligation, there are no legal grounds for amending the contracts, which, in addition, might have also breached prudential rules. Based on the initiative of the Association's appointed high-level expert group, the Board decided to meet the government's expectations by rethinking its previous proposals, by also taking into account those civil society proposals that meet the criteria set by the government. The revised proposal package was submitted to the Ministry for National Economy in late October.
For home loans, the package proposed making the Exchange Rate Scheme mandatory for a wider range of customers, in accordance with the extended definition provided by the new Banking Act, with an opt-out possibility, for CHF and EUR-denominated loans (making up the bulk of fx loans). In relation to litigations, we proposed that in case of a potential annulment of the loan contract, the court

should provide for a settlement obligation in the same proceeding. Proposals included bringing forward the starting date of the winter eviction moratorium and the relinquishing of foreclosures for minor debts.

During the development of the proposals, the high-level working group also examined the possibility of converting the fx residential mortgage loans into HUF and the related consequences. Also, we consulted with external consultants and auditors on the treatment of such conversions under the IFRS. The consultants and auditors both said that in case of a prompt conversion of the loans into HUF at spot rates, the cash-flow deficit over the full loan tenor, arising from the difference between original loan product and the post-conversion loan product, should be accounted for in one amount as a loss. The implementation of the proposals presented to the government would have caused a significant loss for the banking sector, although less than what a prompt conversion of the loans into HUF would have caused.
Finally, the government recommended debtors to join the Exchange Rate Cap Scheme, whose eligibility and other conditions have been significantly relaxed.

Supreme Court legal uniformity decision, Constitutional Court motion

Since the autumn of 2013, political communications have increasingly called for a legal solution to the serious social problem of fx debtors, naming the Supreme Court's and the Constitutional Court's potential decisions as a starting point for a solution. On November 25, the head of the Supreme Court's Civil Department published his motion for a legal uniformity procedure, putting seven questions addressing the matters of principle raised in the related case laws regarding the validity of foreign currency-denominated consumer credit contracts and consumer leasing contracts. The Association's FX litigations working group analysed the questions and compiled a report on the issue.
On December 16, the Supreme Court published the gist of its legal uniformity decision, followed by the publication of the detailed reasons on December 23. The Supreme Court adopted a legal uniformity decision in most of the questions raised, in line with the current legal framework and with the vast majority of the decisions previously adopted by courts. Of the questions raised, the Supreme Court did not address the question of the fairness of unilateral contract amendments, in view of the ongoing case before the European Court of Justice. A decision in the case may be adopted by the ECJ in the spring.

In its motion of November 28, the government asked the Constitutional Court to interpret the Fundamental Law in two questions. First: "*whether or not it can be derived from Paragraph (2) of Article M) of the Fundamental Law that a contractual provision applied en masse in a manner causing consumers a unilateral and material disadvantage, in particular, by assigning the exchange rate risk solely to the customer and giving the creditor a relatively free and wide discretion to raise the interest rates, and the contractual provision on the application of a spread and the relevant court decision confirming it, and the statutory provision serving as a ground for such provision and court decision are contrary to the Fundamental Law*. Second: the government asked the Constitutional Court to interpret "*Article II and Paragraph (1) of Article B) of the Fundamental Law in terms of under what constitutional conditions other than those provided by the Constitution may existing contracts be amended by law*."
The litigations working group discussed the government's motion and developed a common position.
According to the information published by the Constitutional Court, it will start discussing the motion in late January.

Extension of the eligibility criteria for the Exchange Rate Cap Scheme

The Act cancelling most of the restrictions and opening up the Exchange Rate Cap Scheme for debtors who were previously not eligible for it (e.g., loans past due for more than 90 days, loans exceeding HUF 20 million at the time of conclusion of the loan contract) was promulgated in early November.

The Act also incentivises banks to forgive a part of the debt by providing that a joint and several government guarantee is only available if the debt does not exceed 95% of the value of the property at the time of conclusion of the loan contract.

The new law, adopted without any prior consultation, has raised a number of serious interpretation issues. We reviewed these issues in detail with member banks and submitted questions and amendment proposals to the Ministry for National Economy. Our main amendment proposals included the following:

- the maximum delinquency limit should be uniform for both the current buffer account loans and those to be incurred under the new law (180 days),
- banks' current payment alleviation schemes should not be convertible to an Exchange Rate Cap Scheme arrangement (since this would be unmanageable),
- a government guarantee for the new buffer account loan terms should be developed.
- multiple applications for the buffer account loan should be restricted.

After negotiations with the Ministry for National Economy, conducted with the involvement of specialists from member banks, an acceptable legislative solution was found.

Changes in the definition of home loan

The definition of home loans in the new Banking Act has been adjusted in several points. This means some major changes:

- The definition for home loans has been extended to include loans replacing such loans. (This may have an impact in case of a potential debtor rescue package or in applying the Consumer Credit Act in the case of early repayments),
- In the case of foreign currency-denominated loans, the mid-rate should be applied not only to home loans (as extended above) but to all retail mortgage loan types in respect of disbursement, repayments (including early repayments) and fee calculations.
- The customer will have the right to apply for extension of the loan period every five years, for any retail mortgage loan type (previously, this right only applied to home loans in their narrow sense).
- 90^+ customers will have the right to a one-time, maximum five-year, extension of the loan period, free of charge, for any retail mortgage loan type (previously this right only applied to home loans).
- Prior to the termination of a mortgage loan, the debtor should be informed in detail on how his debt has been arrived at.
- If, by amending the contract, the principal debt grows by more than 10 percent, the debtor's creditworthiness should be re-assessed, free of charge. This provision applies to all retail mortgage loan types.

We organised a meeting with the Ministry for National Economy with the involvement of specialists from member banks. At this meeting, in addition to some minor changes and adjustments to the provisions of the legislation, we managed to ensure, inter alia, the following:

- the definition of replacement loan has been clarified
- in the case of terminated loans, the breakdown of debt history information has been changed from monthly to annual and the entry into force of the relevant provision of the legislation has been postponed by several months in view of the busy year-end period.

V. Major regulatory developments affecting banks

New Banking Act, financial omnibus legislation

Parliament passed the new Banking Act in December. In terms of contents, the new Act is basically the same as the former one. However, due to the several amendments it had undergone in the past 20 years and the ensuing fragmented structure, it was timely to re-edit the legislation. A new element in the new Act is the implementation of CRD IV: the prudential rules and corporate governance rules have been tightened, reliance on credit rating agencies has been narrowed and new capital buffers have been introduced. The consumer protection provisions of the Act have been modified and become more favourable for the customers.

From 2014, the operational framework for credit institutions will be determined by the new Banking Act and EU Regulation 575/2013 on prudential requirements for credit institutions and investment firms.

In the context of the new Banking Act it should be noted that a separate Act has been enacted on non-bank payment service providers and voucher issuers. We followed closely the drafting of this legislation, since these institutions carry out activities partly similar to those performed by banks, without a banking licence. Therefore, sector-neutral regulation is a fundamental requirement.

The implementation of the CRD, adopted together with the CRR, made it necessary to amend the Act on Investment Services as well as other acts. The relevant omnibus legislation also contains legislative amendments related the new supervisory functions of the MNB.

Drafting of the legislation on collateral register, related issues

The collateral register under the new Civil Code is aimed to provide information on lien established on other assets, rights and receivables, in addition to real estates, registered chattels and registered rights. Registration in the collaterals register will be a precondition for establishing a lien. Furthermore, data related to sales with retention of title and factoring and leasing contracts will also have to be registered.
Act CCXXI of 2013 provides detailed rules for the operation of the register. The Association was involved in the drafting of the legislation. In our comments we drew attention that the system will not be able to fully take over the role of fiduciary collaterals, since it will not be possible to establish whether the specific assets, rights and receivables in the register are free of encumbrance. The system is expected to impose significant financial and procedural burdens on users.
The law was passed with minor amendments on December 9, 2013 and will take effect on March 15, 2014. A serious concern is that the relevant implementation decrees have not been issued yet. (We have no information as to when the ministerial decrees on the operation of the system, on inquiries from the system, on the electronic forms for the required statements and on cost reimbursement will be issued). The operator of the register, the Hungarian Chamber of Notaries says the system will be operable on March 15. The development of the required systems on the creditors' side should be started already now (internal procedures, IT development). However, this can only be done once all the relevant regulations are available.

Act on fiduciary asset management

The new Civil Law introduces the institution of fiduciary into Hungarian law. A fiduciary undertakes to manage the assets, rights and receivables entrusted to him by the principal under a fiduciary asset management contract. The Civil Code specifies the common law framework for this new legal institution, while the related public law regulations (such as licensing) will be set out in a separate Act on fiduciaries and the rules for fiduciary activities.
We provided comments on this latter draft legislation on two occasions to the Ministry of Administration and Justice. We objected to the fact that financial institutions are excluded from fiduciary activities (the law provides that fiduciary activities can only be performed as a sole activity). In addition, we provided amendment proposals to the related laws and proposals for the detailed operational rules. The Parliament is expected to discuss the draft law during its spring session.

Preparing for implementation of the new Civil Code

Preparing for implementation of the new Civil Code is a key task for banks. This includes a learning process for their legal staff and adjusting operations to the new legal requirements. (Revising the bank's general terms and conditions, business rules, internal procedures, forms, customer information documents, etc.).
To promote the process, the Association organised seminars to present the main parts of the new Civil Code affecting banking. Seminars were held in Q4 on the chapters on legal entities, companies and securities, the latter in collaboration with the Association of Securities Dealers.
In addition, we followed and commented on proposed amendments to the following laws related to the Civil Code:

- Act CLXXVII of 2013 on transitional and authorising provisions related to the entry into force of Act V of 2013 on the Civil Code,
- Act CLXXVI of 2013 on the transformation, merger and demerger of legal entities
- Act CCXXXVI of 2013 amending certain financial acts
- Act CCLII of 2013 amending certain acts in relation to the entry into force of the new Civil Code.

VI. Developments regarding financial supervision

MNB-PSZÁF merger

The working group set up to address technical issues left open by the new Act on the Central Bank commenced operations on October 2, identifying and prioritising the issues to be clarified in connection with the merger of PSZÁF into the MNB. A letter initiating the tackling of the issues raised was sent to the MNB Governor on October 10.
In his reply in late November, the MNB Governor supported the proposal for dialogue between the sector and the central bank in respect of all of the issues raised and reaffirmed that supervisory activities will continue smoothly during the transition.

Consultation on liquidity regulation

Following a consultation by member banks' treasury and market risk specialists, in early October 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.
In his response, the Deputy Governor informed that CRR implementation issues are addressed at the MNB by a newly set up Liquidity Working Group. The working group held its first meeting in early December.
In relation to the issues raises in our letter, we organised a consultation between the central bank and banks in late November. Representatives from the central bank said they did not find banks' proposals regarding collaterals warranted and the MNB did not wish to extend the scope of central bank eligible collaterals to securities. In relation to the CRR, they said that, based on the information they had, they did not see any systemic implementation concern. According to them, compliance with liquidity rules was a major concern and the MNB does not have any tools to help banks meet them. They also said that, to ensure smooth implementation, the MNB was looking forward to receiving information from banks regarding any issue that may arise. We collected banks' comments in two rounds regarding the interpretation of the various provisions of the CRR and sent them to the MNB Liquidity Working Group.

BUBOR reform

As an important step in the process of the BUBOR reform launched in the wake of the PSZÁF recommendation issued in April, the Hungarian Forex Association compiled a draft agreement for cooperation in the redesign of the rate-setting process. The agreement was finalised in November and is now waiting for approval by the MNB.
In line with the PSZÁF recommendation, the Hungarian Forex Association in December initiated the reduction of the number of BUBOR maturities from 15 to 9 effective February 2014. We circulated this proposal to member banks. They had no objections.

Central bank reporting

The MNB published for public consultation the draft decrees on its financial supervisory reporting requirements for 2014 in November and held consultation on the changes in the reporting requirements in December. Most of the changes are related to the implementation of the CRR and those EBA Implementation Technical Standards that contain reporting requirements. In addition, some adjustments and clarifications have been made based on our answers provided to specific practical issues, to improve data quality. The central bank launched a general review of the reporting requirements in the wake of the merger with PSZÁF. The benefits of this review will be first felt in the reporting requirements for 2015.

VII. Payments

Increase in the Financial Transaction Levy

Under the new legislation, enacted as of August 2013, the financial transaction levy rate for cash withdrawals has been doubled (to 0.6%), with the former HUF 6,000 cap removed, and the general transaction levy rate for other transactions has been increased from 2% to 3%. As an additional measure, a healthcare contribution of 6% has been imposed on interest income earned after August 1, 2013, in addition to the personal income tax.

As was the case in early 2013, even after this increase in the FTL in the summer, it can be said that the vast majority of banks, despite the increased costs, continue to keep payments by bank card free of charge, thus promoting the use of this modern cashless payment method.

The PSZÁF and as its legal successor, the MNB have been continuously monitoring the passing on of the Financial Transaction Levy to customers. Based on the investigations, it can be established that banks show high standards of compliance with the law, the number of cases of non-compliance was insignificant.

At the request of the Tax Authority, in December we commented on the proposed FTL returns from for 2014, requesting clarifications and guidance regarding the definition of transactions deemed as cash transactions and issues related to self-revision.

Legislation on free cash withdrawals twice a month, related decree – consultations with the Ministry for National Economy

The reduction of utility prices, launched by the government, has reached the financial sector: upon an individual MP motion, Parliament has incorporated a new provision into the Act on Payment Services. Pursuant to this, cash withdrawals twice a month up to HUF 150,000 in total are now a consumer right. The consumer may exercise this right in respect of one bank account designated by him, which means that if he has several accounts, he has to choose. The customer must apply for the free cash withdrawal option by providing a statement. The text of the statement is provided by the relevant Economic Ministry Decree. Consumers may first exercise the free cash withdrawal right from February 1, 2014, subject to submitting the relevant statement, either in person or online, by January 20, 2014. Thereafter, statements submitted by the 20th day of the month entitle the customer to exercise the free cash withdrawal right from the first day of the next month.

To make sure that the customer has only designated one account for the free cash withdrawal option, a central register will be set up under a separate law, to store and manage the related customer statements. Although this separate law has to be enacted by the end of 2014, we are now making efforts for it to be enacted still in this Parliamentary cycle and for BISZ Zrt. to be appointed by law as the manager of the central register.
Ever since the proposal for the free cash withdrawal option was issued, the Association has voiced its counter-arguments at all forum, including the relevant Parliamentary committees, stressing that the proposal contravenes the principles of a market economy: it requires the service provider to provide a service involving costs free of charge, it will push consumers into the shadow economy and set back financial innovation for decades. We also presented that a number of bank account packages do contain free cash withdrawals, although the number of such packages has decreased due to the introduction of the Financial Transaction Levy. One of the biggest contradictions of the free cash withdrawal option is that while the state requires banks to provide a service free of charge and sustain the ensuing loss, the state itself does not relinquish collecting tax on the service, since banks are required to pay a Financial Transaction Levy on all cash withdrawals.

Other developments related to bank cards

Statutory reduction of IC fees, preparing for the changes

The Act amending certain laws in connection with the merger of financial supervisory authority into the central bank has enacted a new regulation of interbank interchange fees. This caps the interbank interchange fees for debit and credit cards at two and three percent, respectively, effective January 1, 2014. The caps are applicable to domestic transactions, that is, where both the issuer and the acquirer have their head offices/branches in Hungary. This regulation is unprecedented in Europe in terms of both extent and introduction date, since the European Commission's proposal, envisaging similar rates in the EU provides for an implementation period of two years. While the European Commission may only decide on the legislation in the autumn of 2014 at the earliest, the application of the reduced fees is being tested in a "live environment" in Hungary. The "addressees" of the regulation are banks, the required system adjustments have been carried out by the card associations. The question is how the restructuring of the business models will affect the development of the Hungarian bank card market, which thus far has seen significant growth even by international comparison. Over the past year and a half, the Association has drawn attention at all forums to the potential risks of an inadequately drafted regulation.

The Association turned to the Prime Minister Viktor Orbán and leaders of the Ministry for National Economy in several letters in connection with current measures affecting payment services, including the raise of the Financial Transaction Levy and the caps on interchange fees, however, thus far without success. In our letters we pointed out the risks entailed by the regulations adopted by Parliament: the disproportionately high limit for free cash withdrawals and the retention of the FTL on card payments may trigger negative processes in the Hungarian economy, for example, an increase in cash payments and the growth of the shadow economy.

POS deployment project

International research and an MNB study on the social costs of using cash have revealed that modernising payments and promoting the use of electronic channels may result in savings in excess of HUF 100 billion for the economy. In line with these objectives, the MNB initiated a project for the deployment of POS terminals to merchants, aimed to promote bank card payments. The programme was financed by Mastercard. The deployment of the POS terminals was carried out by six institutions providing card acceptance services (BB, Erste, K&H, OTP, Six Payment Services and Takarékbank). The project was supported by the Fejér Country Chamber of Commerce and Industry. Participants contributed with comprehensive organisational work and the allocation of resources for the project. The Association assisted in coordination as a member of the Project Steering Committee. Merchants

and service providers in Fejér County can use the POS terminals at preferential terms for two years. The deployment of POS terminals started in September and the deadline for joining the project was December 31, 2013. A key objective of this pilot project is to obtain information on the main obstacles to the spread of card acceptance as well as on the opportunities, thus contributing to the modernisation of payment services.

EU Payment Accounts Directive

At the request of the Ministry for National Economy, we commented several times on the proposed Directive. The Directive aims to promote the comparability of bank account fees and help EU citizens in opening basic payment accounts and switching banks.
The supervisory authority already has a system in place for the comparison of bank account fees as proposed in the Directive. However, the ex-post annual fee information requirement would impose extra tasks on service providers. We requested the Ministry to advocate at the EU forums for an information requirement that is much less extensive in terms of the amount of data to be provided, and more transparent for the customer.
We proposed that the Ministry should not support facilitating bank switching at the EU level, since this is intended to address an unlifelike situation and would require the development of a highly expensive and complicated system. Switching banks means that the customer decides to move his banking relationships (receiving salary, making utility payments) to another bank, to pay less fees. The regulation on bank switching is aimed to promote the moving of banking relationships between banks. When the customer moves abroad, he will have completely new banking/payment relationships (new employer, new utility providers), in other words, the customer cannot keep and move his old banking/payment relationships to the new bank, so, what happens is actually not bank switching.
In commenting on the proposed Payments Accounts Directive, we proposed that the Directive should allow as much national discretion as possible, since the tackling of social issues (including the issue of basic payment accounts) is a matter for the individual member states. During consultations at the EU level, the proposed Directive has been amended favourably for banks in several points..

VIII. Taxation, accounting

We reviewed and provided proposals on the proposed tax changes for 2014. We welcomed the fact that our year-long efforts for the tax exemption of loan forgiveness have been successful: effective 2014, loan forgiveness – under certain conditions – is tax-free, both for the creditor and the debtor. After several attempts, we also managed to have our request accepted that the personal tax rules for HUF conversion should preferably remain unchanged, since the current systems in place on the payer's side are functioning well and the proposed amendment submitted to Parliament would generate unnecessary IT development requirements and costs.
The potential extension of the Financial Transaction Levy to investment services created significant legal uncertainty. Namely, we had no official response to the question whether this measure, set out by the relevant legislation to be imposed subject to the entry into force of the EU FTT, would be implemented from 2014. Due to the diverging positions of member states, the relevant negotiations in the EU have come to a standstill, so, the sector could be relieved that the extension of the FTL to investment services, a measure that would adversely affect investment services and business processes, will not be implemented from 2014.
The Ministry for National Economy also accepted our proposal for amending the rules for the credit institution contribution on the transfer of provisions to retained earnings. With this amendment, the contribution will be of a company tax nature, clearer and more manageable: the transfer of provisions to retained earnings has become optional and banks may choose to only transfer a part of the stock of provisions (as opposed to the former regulation, which required the transfer of the whole stock of provisions into retained earnings).

In addition to the taxation rules, the treatment of general risk provisions has entailed changes in the relevant accounting rules. Effective fiscal year 2014, banks may not increase their risk provisions, and existing risk provisions may only be reduced if used. The rules for the use of risk provisions are rather

narrow, allowing provisions to only be used for losses not previously covered by impairment/provisions.

The Government Decree on accounting rules for credit institutions has been amended in accordance with our proposal regarding the mandatory accounting order of repayments, by providing that repayments should be accounted for according to the mandatory accounting order for repayments, unless otherwise provided. This provisions facilitates the application of the Civil Code provision allowing for a deviation from the mandatory accounting order, if such deviation is in favour of the debtor. During the review of the proposed regulation, we also requested some other regulatory amendments aimed at convergence to the IFRS. The Ministry responsible for drafting the legislation said it was open to discuss some of these proposals in 2014.

IX. Bank security

FX debtor demonstrations

Demonstrations by radical fx debtor groups continued in the fourth quarter. As a new element, “chanting” demonstrations appeared. The essence of this form of troublemaking is that some people pretending to come to manage their financial affairs appear at the branch (in the concrete cases they also took queue numbers) and at a certain point in time, one of them starts reciting a revolutionary poem, in a loud and disturbing manner, in many cases harassing the real customer, leaning close to them and shouting. When the security guard takes action (escorting the demonstrator out), a second demonstrator starts doing the same and this is repeated again and again. The legal status of these demonstrations is uncertain and may also raise consumer protection issues. Therefore, we requested rulings from the National Police Headquarters and the MNB as to what measures banks can take.

Cooperation with the National Police Headquarters

Discussions with the National Political Headquarters in Q4 were focused on the following issues:

- The Police has introduced a new emergency, operation control and deployment system effective December 8, 2013. Under this, the power to deploy police staff upon bank alerts has been assigned to operation control centres. This means that the formerly used direct telephone contacts with the various Police units will no longer guarantee a prompt response. To remedy the issue, the National Police Headquarters offered to make available to banks dedicated direct telephone numbers to the operation control centres, if the Hungarian Banking Association undertook to finance the investment and operating costs. Discussions on the relevant technical, procedural and financing details are now in progress.
- In September, several member banks received handwritten threats written on their reply letters sent in response to requests from the Police for the disclosure of bank secrets in connection with an ongoing criminal investigation. Given that the sender was unknown and the threats contained pieces of information on the individuals involved in the criminal case and on employees involved in the responses that were not publicly available and it could be assumed that these pieces of information might have been obtained by unauthorised persons, we conducted a joint investigation with the Police in October-November. The investigation revealed that during the presentation of the charge, the Police had legally made available to the suspects and their lawyers copies of the banks’ answers, and it was one of those persons involved who had added handwritten remarks to the letters and sent them to the banks.
  Although the investigation authority acted lawfully, this incident has highlighted the possibility of potential abuse with data of banks or bank staff contacted in criminal investigations. To solve the issue, we initiated a legislative amendment with the Minister of Interior in January.
- In November, the National Police headquarters launched an internal review to identify any other issues that might arise in connection with data inquiries related to criminal investigation, with a view to improving the relevant procedures. The Police requested banks’ input and proposals. Work is now in process under the coordination of the Association.

Changes in the government IT security organisation, cooperation with the new GOVCERT

The organisational framework for coordinating and managing critical infrastructures and the IT security of central and local government institutions has changed from March and July 2013, respectively. The Association and banks had had close cooperation with the Theodore Puskás Public Foundation, the organisation operating CERT-Hungary before the enactment of the new legislation. Following the enactment of the new legislation, the tasks of the Foundation have been taken over by the Disaster Management Authority, in respect of critical infrastructure, and the Special Service for National Security, operating the Government Incident Response Team (GovCERT), in respect of central and local government institutions.
The development of cooperation with the new government IT security organisations to promote banks' IT security operations was a key objective in the Association's IT Security Working Group's 2013 work programme. To achieve this, the Working Group met in December with the Head of GovCERT to discuss the possible forms of cooperation.

X. Association developments

Working group meetings

Central Credit Bureau Working Group meeting

The most important agenda item of the Central Credit Bureau Working Group's meeting was the proposed data accuracy strategy to be implemented from January 1, 2014 and the related fee system. The 2011 change in the legislation with the introduction of a "positive debtor list" was a major challenge for the organisation managing the Central Credit Bureau, with the volume of data to be processed trebling compared to the previous years. Data accuracy is key to the proper operation of the system. To achieve this, a new method will be introduced:

The data to be entered into the system will be categorised by priority and each category will be assigned a different permissible error rate. (For example, important data determining the customer's creditworthiness must meet an accuracy rate of 99%, less important data must meet an accuracy rate of 95%). The manager of the Central Credit Bureau, BISZ Zrt. is using different tools to achieve the set accuracy rates. These include:

- sending notices to the reference data reporting entity,
- introducing a new data processing fee policy,
- using input filters to ensure the accuracy of incoming data.

BISZ emphasised that its objective was not to generate incremental revenues, but to incentivise high-quality reporting. BISZ hopes to achieve the set accuracy rates within two or three years.

Cash Working Group meeting

The Cash Working Group's meeting addressed potential opportunities to develop foreign currency trade. The presenter of the topic, the head of a major cash-in-transit company, presented his company's forex trading support system. He said that their objective was not to acquire new markets, but to improve customer service. They would make the system available to customers free of charge and banks that are not their customers ("external players") may also use the service. As for the operation of the system, he explained the following:

- the system can be accessed through GIRO's secure network,
- the system displays the various offers on the company's homepage, providing the opportunity to the various parties to launch negotiations and conclude contracts,

- using the company’s cash-in-transit services is not a requirement for accessing the system,
- any changes are notified to the affected parties by e-mail messages through a secure line.

Participants drew attention to some negative characteristics of the market:

- demand and supply waves appear at all market players at the same time,
- flexible operations are hindered by the fact that at many banks, forex trading belongs to Treasury, whose priorities may not coincide with those of Cash Management.

Participants were of the general view that if the company could offer better availability for external players, it would be worthwhile for them to try the service for a test period. The head of the company said if external players showed serious interest in the large-scale use of the system, the company would be willing to improve the availability of the system for them.

Data Protection Working Group meetings

The Data Protection Working Group held two meetings in the fourth quarter. The meeting held in October addressed issues related to the legal grounds for data processing, information obligations in banks’ practices, the changes in the provision on the prohibition of sub-processors, and issues related to the separation of personal data processing (Section 13/A of the Banking Act).
At is November meeting, the Working Group heard a presentation on data retention times. This was followed by a discussion of banks’ concerns related to video surveillance and proposals related to the data protection and secrecy provisions of the Banking Act.

SEPA Working Group established

In the wake of the agreement concluded with the Hungarian SEPA Association on December 16, 2013, the Hungarian Banking Association’s role in interbank cooperation has been further expanded. Taking over the tasks of the dissolving Hungarian SEPA Association, the Hungarian Banking Association and its new SEPA Working Group will be responsible for cooperation with the European Payments Council (EPC) and the representation of the Hungarian banking industry in the EPC and the development and updating of the national SEPA strategy and national SEPA plan. Tasks will include the coordination of work related to the development of SEPA payment schemes, the promoting of adherence to the existing SEPA schemes and the provision of broad information on the implementation of the Single Euro Payment Area.

Meeting of the extended V4 group in Budapest

In the fourth quarter, the Association actively participated in the consultations between the banking associations of the Visegrád Four countries (the Czech Republic, Hungary, Poland and Slovakia). The V4 countries have similar characteristics and share similar historical experiences, a fact that makes these consultations well-founded and contributes to efficient joint work. The meeting addressed current European and EBF-related issues, the banking sector’s regulatory and taxation patterns, and development trends of the sector, in particular, the expansion of online banking services.

Visiting member banks in the provinces

At the Secretary-General’s initiative, we visited our member banks in the provinces to obtain information about their situation, their strategy and the roles they play in their respective regions. At the visits paid to Duna Takarékbank, South-Transdanubian Regional Bank, Sopron Bank and Kinizsi Bank, associates of the Association were received by top executives of the banks, who presented the main characteristics and specifics of their banks’ operations. These visits provide a good opportunity for building personal relationships and providing members with first-hand information. Another new channel of liaison is the conference call system, launched in Q4. This provides an opportunity for members’ specialists to be involved in operations of the working groups from remote locations.

Events, conferences

In December, we held our regular Tax Forum on next year's tax law changes, in cooperation with Ernst&Young. The technical afternoon addressed tax laws directly affecting banks, in particular, the tax exemption of loan forgiveness, the accounting rules for the partial redemption of long-term savings deposits after three years and the scope and procedure for the transfer of information during the moving of a long-term savings deposit to a new service provider (facilitated from 2014).

The Association's staff members actively participated in other forums and conferences in Q4. Our associates held presentations at the Management Forum's 2nd Financial Consumer Protection Conference and the International Banker Training Centre's training course on the CRR and chaired the IIR's two-day event entitled "The Banking Sector in 2013".

Communications

The Association conducted extensive communications in the fourth quarter, with virtually continuous media appearances. In Q4, we had 1,524 appearances in the media, double the previous quarter's statistics. As was the case in the previous periods, the most frequent were our appearances in the online media, in 840 instances, followed by the print media, in 513 instances, and the electronic media (TV, radio), in 170 instances. Key topics included current issues related to FX loans and the negotiations with the government on potential solutions. In this context, we opened an online gate for customers and civil society organisations and conducted personal communications with a view to helping in understanding the various positions. Other key issues addressed in our Q4 communications included issues related to the Financial Transaction Levy, adjustment to the increased levy rates and the provision of free cash withdrawals twice a month under the "financial overhead cost cutting" legislation enacted by the Parliament.

ANNEX

INTERNATIONAL DEVELOPMENTS:
REGULATION, SUPERVISION - EUROPEAN BANKING FEDERATION

I Global regulation

I.1 Financial Stability Board (FSB[1])

I.1.1 FSB Meeting in Moscow

At its meeting in Moscow on November 8, the Financial Stability Board (FSB) discussed vulnerabilities affecting the global financial system and reviewed work plans for completing core financial reforms.

In relation to vulnerabilities in the financial system, the FSB established that as a result of the measures taken since the crisis, the system coped with the heightened volatility in May and June. Further bouts of volatility in asset prices and capital flows may occur as monetary policies are normalised. Comprehensive stress tests with severe but plausible scenarios are a vital tool for mitigating financial stability risks in the current environment. Authorities should assess the impact on financial institutions of scenarios that encompass both high asset price volatility and an overshooting of long-term interest rates. A decline in secondary bond market liquidity should also be factored in. The FSB welcomed the forthcoming comprehensive assessment to be conducted by the European Central Bank in 2014.

The FSB discussed work plans to complete core financial reforms in 2014. The Basel Committee on Banking Supervision (BCBS[2]) will this year complete policy work on Basel III, including the leverage ratio and the net stable funding ratio and work to address excessive variation in banks' risk weighting of assets.
The FSB also reviewed issues related to systemically important financial institutions, including:

- the development of proposals on the gone-concern loss absorbing capacity for global SIFIs and a framework for the cross-border recognition of resolution actions,
- the list of global systemically important banks (G-SIBs),
- guidance drawn up to assist supervisors in their assessment of financial institutions' risk culture,
- development of a work plan, jointly with the IMF and World Bank, to improve supervisory effectiveness,
- systemically important insurance companies,
- non-bank non-insurance global SIFIs.

[1] Financial Stability Board: the top organisation coordinating the work of international standard setting bodies.
[2] 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.

The FSB reviewed the 2013 Global Shadow Banking Monitoring Report and discussed the work plan for implementing policy recommendations to strengthen oversight and regulation of shadow banking, issued in August. The regulatory standards and capital requirements for exposures to central counterparties (CCPs) will be finalised in early 2014.

The FSB heard updates from the Chairs of the International Accounting Standards Board and the US Financial Accounting Standards Board on their work to improve and converge accounting standards, loan loss provisioning and insurance contracts. The FSB discussed work underway in the International Forum of Independent Audit Regulators (IFIAR) to improve the quality of audits of global SIFIs. The FSB invited the IFIAR to report back on progress in late 2014.

I.1.2 Update of the list of G-SIBs

Based on the relevant methodology published in July, the FSB updated its list of global systemically important banks for the third time in 2013. G-SIBs included in the list will be required to meet higher loss absorbency requirements to cover risks arising from their size. The higher loss absorbency requirements will be phased in from January 2016, with full implementation by January 2019.
One bank has been added to the list of banking groups identified as G-SIBs in 2012, increasing the overall number from 28 to 29. Based on the current categorisation, out of the 29 SIFIs, 15 are in the 1% bucket, 8 in the 1.5% bucket, 4 in the 2% bucket and 2 in the 2.5% bucket. The 3.5% bucket is currently empty. (The scores and the current assignment of the G-SIBs to the buckets are provisional; the assignment relevant for the higher loss absorbency requirement will be based on the most current available data prior to implementation). The initial requirements in January 2016 will apply to G-SIBs identified in November 2014. Newly identified G-SIBs will have to set up a Crisis Management Group (CMG) within 6 months following the date of their G-SIB designation. The deadline for the development of a recovery plan and the development and review of a resolution strategy with the CMG is 12 months. An institution-specific cooperation agreement will have to be agreed and an operational resolution plan developed within 18 months. The deadline for the conduct of a resolvability assessment by the CMG and for the resolvability assessment process is 24 months.

The FSB and the standard setting bodies continue to extend the SIFI framework to other systemically important financial institutions. In July 2013, the International Association of Insurance Supervisors (IAIS) published a methodology for identifying global systemically important insurers (G-SIIs) and a set of policy measures that will apply to them. The FSB, in consultation with the IAIS and national authorities, identified an initial list of nine G-SIIs. The FSB will issue a proposed assessment methodology for identifying non-bank non-insurance global systemically important financial institutions.

I.1.3 FSB papers for more effective supervision of risk management

In November, the Financial Stability Board (FSB) published two papers to assist supervisors in strengthening risk management practices at financial institutions. The FSB Principles for an Effective Risk Appetite Framework were finalised by taking into account the results of the public consultation launched in July. Concurrently, the FSB issued for public consultation its Guidance on Supervisory Interaction with Financial Institutions on Risk Culture. The FSB pointed out that the Principles and Guidance aim to support well-informed and forward-looking risk decisions by institutions, and to assist the understanding, by both the financial institution and the supervisor, of the institution's risk culture, in particular whether it supports appropriate behaviours and judgements within a strong risk governance framework.

I.1.4 Shadow banking monitoring

The Financial Stability Board (FSB) published its third annual Global Shadow Banking Monitoring Report. The report includes data from 25 jurisdictions and the euro area as a whole; these jurisdictions represent about 80% of global GDP and 90% of global financial system assets. In the FSB’s rough

estimate, the assets of non-bank financial intermediaries (excluding those of insurance companies, pension funds and public financial institutions) grew by USD 5 trillion in 2012 to reach USD 71 trillion. Non-bank financial intermediaries represent about 24% of total financial assets and are equivalent to about half of the banking system's assets and 117% of GDP. These patterns have been relatively stable since the crisis. Non-bank financial intermediaries grew by 8.1% in 2012, partly as a result of a general increase in the valuation of global financial markets, while bank assets were relatively stable. The global growth trend of non-bank financial intermediaries masks considerable differences across jurisdictions. Non-bank financial intermediaries form a larger proportion of domestic financial systems in advanced economies than in emerging markets. However, non-bank financial intermediaries in emerging market jurisdictions have experienced strong growth.

I.2 Basel Committee on Banking Supervision

The BCBS's Regulatory Consistency Assessment Programme (RCAP), adopted in 2012 consists of two distinct but complementary work streams to monitor the timely adoption of Basel III standards and to assess the consistency and completeness of the adopted standards, including the significance of any deviations in the regulatory framework. Currently, the focus of the RCAP is on risk-based capital. This will expand from 2015 to cover Basel III standards on liquidity, leverage and systemically important banks (SIBs). The document, published in October, describes the procedures and process for conducting jurisdictional assessments under the RCAP.

A key element of the BCBS regulatory programme is the ***fundamental review of capital requirements for the trading book***. The second consultative document, published in October, provides more detail on the approaches introduced in May 2012, based on comments received on the first consultative paper and lessons learnt from the Committee's recent investigations into the variability of market risk-weighted assets. The key features of the proposed revised framework include:

- A **revised boundary** between the trading book and banking book. The new approach aims to create a less permeable and more objective boundary that remains aligned with banks' risk management practices and reduces the incentives for regulatory arbitrage.
- A **revised risk measurement approach and calibration**. The proposals involve a shift in the measure of risk from value-at-risk to expected shortfall.
- The incorporation of the risk of **market illiquidity**, through the introduction of "liquidity horizons".
- A **revised standardised approach** that is sufficiently risk-sensitive.
- A **revised internal models-based approach**, including a more rigorous model approval process.
- A **strengthened relationship between the standardised and the models-based approaches**. This is achieved by establishing a closer calibration of the two approaches by requiring mandatory calculation of the standardised approach by all banks.
- A **closer alignment between the trading book and the banking book** in the regulatory treatment of credit risk. This involves a differential approach to securitisation and non-securitisation exposures.

The Committee is also considering the merits of introducing the standardised approach as a floor or surcharge to the models-based approach. However, it will only make a final decision on this issue following a comprehensive Quantitative Impact Study. Comments on the consultative document were invited by January 31, 2014.

Revisions to the securitisation framework are also an important part of the Basel Committee's agenda. The BCBS's second consultative document follows the first consultative document published in December 2012. In developing its proposals, the Committee took into account the comments received on the first consultative document, as well as the results of the related quantitative impact study (QIS). The new proposal reflects the Committee's desire to strike an appropriate balance between risk sensitivity, simplicity and comparability. Relative to the first consultation, the major changes in the

consultative document apply to the hierarchy of approaches and the calibration of capital requirements.
For the hierarchy, the Basel Committee proposes a simple framework similar to that used for credit risk:

- Where banks have the capacity and supervisory approval to do so, they may use an internal ratings-based approach to determine the capital requirement based on the risk of the underlying exposures.
- If this internal ratings-based approach cannot be used for a particular securitisation exposure, an external ratings-based approach may be used (assuming that the use of ratings is permitted within the relevant jurisdiction).
- if neither of these approaches can be used, a standardised approach would be applied.

In reviewing the calibration of the approaches, the Basel Committee revised some of the modelling assumptions behind the original calibration proposed in the first consultative document. The result is to significantly reduce capital requirements compared to the initial proposals, although the capital requirements remain more stringent than under the existing framework. The Committee also proposes to set a 15% risk-weight floor for all approaches, instead of the 20% floor originally proposed. Comments on the proposals are invited by March 21.

Other important BCBS documents published in Q4 include the following:

- Liquidity stress testing: a survey of theory, empirics and current industry and supervisory practices (working paper)
- Capital requirements for banks' equity investments in funds - final standard
- Progress in adopting the principles for effective risk data aggregation and risk reporting
- Longevity risk transfer markets: market structure, growth drivers and impediments, and potential risks

I.3 USA – Adoption of final rules implementing the Volcker Rule

In December, the U.S. regulatory agencies adopted final rules to implement the Volcker Rule. These prohibit insured depository institutions and companies affiliated with insured depository institutions (banking entities) from engaging in short-term proprietary trading of certain securities, derivatives, commodity futures and options on these instruments, for their own account. They also impose limits on banking entities' investments in, and other relationships with, hedge funds or private equity funds. The final rules provide exemptions for certain activities, including market making, underwriting, hedging, trading in government obligations, insurance company activities, and organizing and offering hedge funds or private equity fund. The final rules also clarify that certain activities are not prohibited, including acting as agent, broker, or custodian. The U.S. President welcomed the adoption of the final rules. However, the Financial Services Roundtable says the new regulation will produce an uneven playing field for U.S. firms.

II. European regulation

II.1 Agreement on the Bank Recovery and Resolution Directive

In December, a compromise was reached on the contents of the BRRD. The compromise enables the Directive to be adopted by the European Parliament and Council Directive on first reading and to take effect in all member states on January 1, 2015. The draft directive establishes a range of instruments to tackle potential bank crises at three stages: prevention, early intervention, and resolution. Banks will have to draw up recovery plans and update them annually, setting out the measures they would take to restore their financial position in the event of significant deterioration. Resolution authorities will have to prepare resolution plans for each bank. The main resolution measures would include:

- the sale of (part of a) business;

- establishment of a bridge institution (the temporary transfer of good bank assets to a publicly controlled entity);
- asset separation (the transfer of impaired assets to an asset management vehicle)
- bail-in measures (the imposition of losses, with an order of seniority, on shareholders and unsecured creditors).

Authorities will also have the power to appoint "temporary administrators" or special managers to an institution if its financial situation were to deteriorate significantly or if there were serious violations of the law.

The bail-in provisions, which will enter into force on January 2016 (as opposed to the Commission's initial proposal of 2018), will enable resolution authorities to write down or convert into equity the claims of the shareholders and creditors. A minimum level of losses equal to 8% of total liabilities including own funds will have to be imposed on an institution's shareholders and creditors before access can be granted to the resolution fund. Certain types of liabilities will be permanently excluded from bail-in:

- covered deposits;
- secured liabilities including covered bonds;
- liabilities to employees of failing institutions, such as fixed salary and pension benefits;
- commercial claims relating to goods and services critical for the daily functioning of the institution;
- liabilities arising from a participation in payment systems which have a remaining maturity of less than seven days;
- inter-bank liabilities with an original maturity of less than seven days.

Deposits above 100,000 from natural persons and micro, small and medium-sized enterprises will have preference over deposits from large corporations. National resolution authorities will also have the power to exclude, or partially exclude, liabilities on a discretionary basis for the following reasons: if they cannot be bailed in within a reasonable time; to ensure continuity of critical functions; to avoid contagion; to avoid value destruction that would raise losses borne by other creditors.

The directive requires member states, as a general rule, to set up *ex-ante* resolution funds. These national funds will have to reach, by 2025, a target level of at least 1% of covered deposits of all the credit institutions authorised in their country. To reach the target level, banks will have to make annual contributions, based on their liabilities (excluding own funds and covered deposits) and adjusted for risk. The contribution of the resolution fund is capped at 5% of a bank's total liabilities. (In relation to the resolution funds, a number of detailed rules have been agreed).

The directive offers the possibility, under exceptional circumstances and subject to state aid rules, to temporarily inject capital into solvent banks that cannot access private funds. However, this precautionary measure is limited to injections necessary to address capital shortfalls revealed during stress tests, asset quality reviews or equivalent exercises conducted by the European Central Bank, the European Banking Authority (EBA) or national authorities. A stabilisation tool will allow for public capital injections in an emergency situation where an extensive bail-in of creditors could endanger financial stability. However, this would be subject to the 8% bail-in and conditional on approval by the Commission.

To ensure that banks always have sufficient bail-inable liabilities, the directive provides for national resolution authorities to set minimum requirements for own funds and eligible liabilities (MREL[3]) for each institution, based on its size, risk and business model. A review in 2016 will enable the Commission, based on recommendations by the EBA, to introduce a harmonised MREL applicable to all banks.

[3] Minimum requirements for own funds and eligible liabilities

II.2 Agreement on the Deposit Guarantee Scheme Directive

In view of the close link between resolution funds and deposit guarantee schemes, the Deposit Guarantee Scheme Directive (DGSD) and the relevant provisions of the BRRD were discussed in parallel. Accordingly, the agreement on resolution funds also entailed an agreement on deposit guarantee schemes. Under this, the repayment deadlines will be gradually reduced from the current 20 working days to 7 working days, regardless of the size of the bank. The reduction will be made in three phases: 15 working days from January 1, 2019, 10 working days from January 1, 2021, and eventually, 7 working days as from January 1, 2024.

Deposit guarantee funds will have to be funded ex-ante, member states will not have the option to choose between the ex-ante or ex-post funding models. The minimum target level will be 0.8 % of covered deposits. The minimum target level must be met within 10 years of the recast Directive entering into force. (The Commission may permit a member state to set a lower target level for its DGS in the case of highly concentrated banking sectors, but not lower than 0.5% of covered deposits). The directive will allow the use of payment commitments backed by high-quality assets and the use of tax levies. Under the system of risk-based contributions, banks with riskier business policies will have to pay higher contributions. The Directive will allow DGSs to borrow from each other.

The new Directive will require better, and standardised, information to be provided to depositors.

In its press release, the European Banking Federation (EBF) welcomed the agreements on the BRRD and the DGSD and pointed out that these agreements will contribute to improving the soundness of and strengthening confidence in the financial system. According to calculations by the industry, a bail-in threshold of 8% of total liabilities would have been enough to absorb the losses in the most recent cases of bank failures. Thus, the EBF is confident that the bail-in regime will be effective and minimise the likelihood to impose further losses on senior creditors, resolution funds or to require further government support. The requirement for banks to build-up at member state level a separate ex-ante financed resolution fund, combined with the deposit guarantee funds is estimated to amount up to EUR 155 billion worth of bank financing over the next 10 years, hence the, EBF welcomed the flexibility for member states to use alternative instruments for filling up the funds.

II. 3 Banking union

II.3.1 Single Supervisory Mechanism (SSM)

The Council Regulation conferring specific tasks on the European Central Bank concerning the prudential supervision of credit institutions was issued with a considerable delay compared to the original schedule, on October 15, 2013[4]. Meanwhile, preparations at the ECB are in full gear for the taking over of direct supervision of major European banks in November 2014.

The ECB signed agreements with the European Parliament in November and with the Council in December. The purpose of these agreements, inter alia, is to work together in developing and setting up the SSM as soon as possible. The agreement (Memorandum of Understanding) signed with the Council provides that in accordance with the principles of accountability, the annual report of the Chair of the SSM Supervisory Board will have to be sent in advance to the Council. The agreement sets out the scope of information to be provided in the report. During the start-up phase, the ECB shall submit to the Council quarterly reports on progress in the operational implementation of the Regulation. The Chair of the Supervisory Board shall participate in two exchanges of views per year with the Eurogroup (and in additional exchanges of views at the invitation of the Eurogroup) in the

[4] Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions

presence of representatives from any participating member state whose currency is not the euro. Furthermore, questions put to the ECB by the Eurogroup shall be replied by the Chair within 5 weeks. The Memorandum of Understanding also sets out the powers of the Council in the selection and appointment of the Chair of the SSM.

Pursuant to the Regulation, members of the SSM Supervisory Board include the Chair, the Vice-Chair (chosen from members of the ECB Executive Board), four representatives of the ECB (Directors General of the ECB) and one representative of the national competent authority of each participating member state. The Chair is elected for a term of five years, the term is not renewable. The ECB proposed Ms Daniele Nouy as the first Chair of the SSM. Her appointment was endorsed by the European Parliament on December 11. The four Directors General to the SSM were appointed by the ECB in early January 2014.

The regulation also provides that where necessary, the ECB should enter into memoranda of understanding with competent authorities responsible for markets in financial instruments, describing in general terms how they will cooperate with one another in the performance of their supervisory tasks. The ECB shall conclude a memorandum of understanding with the competent authority of each non-participating member state that is home to at least one global systemically important institution. Such memoranda should be made available to the European Parliament, to the Council and to the competent authorities of all member states and should be reviewed on a regular basis.

In October, the ECB published a note on a ***comprehensive assessment*** to be conducted by the ECB and the national competent authorities on banks that will be subject to direct supervision by the ECB (128 in number). Elements of the assessment:

- A supervisory risk assessment (SRA), addressing key risks in the banks' portfolios. It will include a quantitative and qualitative analysis based on backward and forward-looking information.
- An asset quality review (AQR) on banks' on and off-balance sheet exposures, to be conducted after publication of the EBA's recommendations on non-performing exposures. The asset quality review will be risk-based and will concentrate on those elements of individual banks' balance sheets that are believed to be most risky and will include market exposures.
- A stress test (ST), to be conducted in collaboration with the EBA in the second half of 2014 by taking into account the results and non-public recommendations of the AQR.

As far as we know, the proposed schedule for the comprehensive assessment exercise is as follows:

- SRA to be completed by February 2014;
- AQR between February and July 2014 in three phases:
    - Selecting the portfolios based on the SRA,
    - Carrying out the AQR, visits to banks,
    - Comparing the results;
- Non-public recommendations for the individual bank groups;
- Stress tests between July and October;
- Publishing the results in October.

In relation to the AQR and stress tests, the EBF requested the European Banking Authority not to require banks to disclose data that should be determined based on assuming full implementation of Basel III, without taking into account the transitional measures. Such disclosures would be confusing in understanding the provisonis of the CRR/CRDIV and might lead to a misdjudement of the bank's financial position.

II.3.2 Single Resolution Mechanism (SRM[5])

[5] Single Resolution Mechanism

There were fierce debates between member states over the Single Supervisory Mechanism. The debates were focused on the SRM decision-making mechanism and the European Commission's role in it, the voting process of the Single Resolution Board (SRB) and the voting proportions, the scope of the SRM, the funding of the SRM (a single fund or cooperation between the national resolution funds), bringing forward the bail-in rules, and the question of where the SRM should be headquartered.

At the ECOFIN[6] meeting of December 18, member states agreed on the contents of the Single Resolution Mechanism, including the establishment of a Single Resolution Board and a Single Resolution Fund (SRF). Member states requested the EU presidency to start negotiations with the European Parliament to adopt the SRM in the current Parliamentary cycle (before the EP elections in May). Members of the banking union committed to transforming their national resolution funds into a Single Fund over a transitional period of 10 years. The Single Fund will complement the bail-in rules of the BRRD, allowing the use of the SRF. The Single Resolution Fund would be financed from bank levies raised at the national level.

The SRF would initially consist of national resolution funds („compartments") that would be gradually merged over 10 years, with a progressively growing share in the resolution costs. (National funds would contribute 10% of their funds in the first year, 20 percent in the second year, to reach 100 percent in the tenth year, and the SRF's share in the resolution costs would also grow accordingly). The ECOFIN ministers also agreed on a backstop for the SRF. During the initial build-up phase of the fund, bridge financing will be available from national sources, backed by bank levies, or from the European Stability Mechanism, in accordance with agreed procedures. Lending between national compartments will also be possible. During this transitional phase, a common backstop will be developed, which would become fully operational after 10 years.

The draft regulation agreed by the Council provides for a single resolution board with broad powers in cases of bank resolution. Upon notification by the European Central Bank that a bank is failing or likely to fail, or on its own initiative, the board would adopt a resolution scheme placing the bank into resolution. It would determine the application of resolution tools and the use of the single resolution fund. Decisions by the board would enter into force within 24 hours, unless the Council, acting by simple majority on a proposal by the Commission, objected or called for changes. The board would consist of an executive director, four full-time appointed members and the representatives of the national resolution authorities of all the participating countries. It would exercise its tasks in either a plenary or executive form. Most draft resolution decisions would be prepared in the executive session, made up of the executive director and the appointed members, with the representatives of member states concerned by a particular resolution decision involved in a first stage. However, the plenary session would be responsible for decisions that involve liquidity support exceeding 20% of the capital paid into the fund, or other forms of support, such as bank recapitalisations, exceeding 10% of funds, as well as all decisions requiring access to the fund once a total of EUR 5 billion has been used in a given calendar year. In these cases, decisions would be taken by a two-thirds majority of the board members representing at least 50% of contributions. The plenary session, voting by simple majority, would also have the right to oppose decisions by the executive session authorising the fund to borrow and decisions on the mutualisation of financing arrangements in the event of the resolution of a group with institutions in both SRM-participating and non-participating EU countries. To guarantee member states' budgetary sovereignty, the draft regulation would prohibit decisions requiring a member state to provide extraordinary public support without its prior approval under national budgetary procedures.

The single resolution mechanism would cover all banks in the participating member states. The Single Resolution Board would be responsible for the planning and resolution phases of cross-border banks and those directly supervised by the ECB, while national resolution authorities would be responsible for all other banks. However, the board would always be responsible if the resolution of a bank requires access to the single resolution fund. Should a national authority not comply with a decision by the board, the board could address executive orders directly to the troubled bank.

[6] Economic and Financial Affairs Council: the Council of EU Finance ministers

The SRM would enter into force on January 1, 2015. Bail-in and resolution functions would apply from January 1, 2016. The SRM regulation wouldn't apply until the intergovernmental agreement entered into force. The intergovernmental agreement would enter into force once ratified by member states participating in the SSM/SRM that represent 80% of contributions to the Single Resolution Fund.

In its comments, the EBF said the Single Resolution Mechanism – with an independent Board and fund - is essential to the Banking Union, therefore, it welcomes the SRM agreement. It pointed out that it is crucial that the SRB is able to take decisions regarding all banks within the SSM whether directly or indirectly supervised by the ECB. An efficient and timely decision-making process for the resolution of cross border banks in the SSM will be of the utmost importance. The EBF highlighted that only a sound decision-making process will facilitate the speed of resolution, which in turn may minimise the wider impact of a bank failure and the need for taxpayer support. The EBF is not sure whether the co-legislators'[7] starting positions are really conducive to efficiency and swift decision-making.

Almost all EBF members are supportive of the creation of a Single Resolution Fund. However, they emphasise the need to deal with the legacy assets of the recent crisis. They believe that bail-in instruments should act as the primary means of absorbing losses in a bank failure and resolution financing would only serve to finance the residual and operational cost of a bank resolution. The EBF recognises the synergies of a common fund and therefore sees no need for a dual system of national and supranational funds.

II.4 Structural reform

In early January 2014, the European Commission completed a draft proposal for the separation of certain trading activities. The proposal in many respects is more permissive than the proposals of the Liikanen HLEG.
The restrictions would apply to

- global systemically important banks (G-SIBs) operating in the EU
- that exceed the following thresholds in three consecutive years:
  (a) the bank's total assets exceed EUR 30 billion and
  (b) the bank's trading assets and liabilities exceed EUR 70 billion or 10% of its total assets.

According to current data, 29 banks are affected.
The territorial scope of the proposed regulation will extend to EU banks, their EU parent banks, subsidiaries and branches, including those operating in third countries. EU banks' subsidiaries operating in non-EU countries and foreign banks' branches operating in the EU will be exempt from the regulation, if equivalent regulations or exemptions are in place in the jurisdiction in question.
Banks covered by the Regulation

- would not be allowed to engage in proprietary trading (specifically aimed at making a profit for their own account, without any connection to current or future customer activity)
- would be prohibited from owning, sponsoring, or having exposure to hedge funds.

In case of exceeding certain thresholds, supervisors will have the power to require the separation of additional trading activities. Activities such as market making, investment and sponsorship of complex securitisation and the sale and trading of derivatives will be under the close watch of supervisors in terms of whether or not they pose a threat to the bank or to the stability of the financial system. The development of metrics for the EBA supervisory review will be the responsibility of the EBA. Sovereign debt trading will not be taken into account. Those member states, where similar separation rules are in place may be granted a derogation under a certificate from the European Commission.
The Commission promises to publish the official draft proposal in January of February. The regulation is not expected to be adopted before December 2015. The ban would apply from 2018, separation should be implemented from 2020.

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[7] Co-legislators: The European Commission, the European Parliament and the Council.

The proposal is apparently the result of several compromises. Accordingly, it provides supervisors wide discretion regarding separation. However, the fact that most of the banks affected by the reform will be subject to direct supervision by the ECB may ensure uniform treatment.

II.5 ESRB[8] assessment on implementation of the recommendation on lending in foreign currency

The European Systemic Risk Board issued a recommendation on lending in foreign currency in September 2011. After two years, the ESRB assessed compliance with the recommendation in member states. According to the assessment, out of the (then) 27 member states, 12 were fully, 14 largely and one (Bulgaria) partially compliant. Hungary was rated as largely compliant because the special capital add-on addressing foreign exchange lending under Pillar II was found insufficient. It should be noted that, according to the data, out of the twenty-seven member states, retail fx lending is only significant in seven (Lithuania, Latvia, Hungary, Romania, Bulgaria, Poland and Austria).

III European Banking Authority

III.1 EBA 2014 work programme

In early October, the European Banking Authority and the Joint Committee of the European Supervisory Authorities published their 2014 work programmes. The EBA's regulatory work will continue to be focused on the Single Rulebook. The detailed rules will affect the CRR/CRD4 (credit and market risk, liquidity and leverage) and the bank recovery and resolution framework. In oversight, the EBA will focus on identifying, analysing and addressing key risks in the banking sector in the EU. It will continue to monitor capital levels and capital plans with the aim of converging towards the new standards. In the area of **consumer protection**, the EBA is committed to enhancing the protection of banking consumers and promoting transparency, simplicity and fairness for consumer financial products and services across the single market. In this context, the EBA will focus on fulfilling mandates assigned to it under the Mortgage Credit Directive (MCD), the Bank Account Package and the Payment Services Directive (PSD). As was the case in previous years, the EBA has classified its tasks into three priority levels.

III.2 Report of the Banking Stakeholder Group (BSG)

The first term of the EBA Banking Stakeholder Group, launched in March 2011, expired in September 2013. The BSG included 10 delegates from credit and investment institutions, 6 academics, 5 consumers, 5 users, 3 delegates from SMEs and 1 employee representative. The BSG's main task is to provide advice to the EBA and review and comment on the various EBA documents, in particular its technical standards. The Stakeholders Group carried out their activities in four working groups (bank liquidity, bank capital, consumer protection and systemic issues) and presented a report at the end of its term. The new Stakeholder Group was appointed in late October. One-third of the former members were reappointed and its Chair was re-elected.

III.3 Risk assessment of the European Banking System

In late October 2013, the EBA published for the first time a report (Risk Dashboard) compiled based on a sample of Key Risk Indicators (KRI) from 56 banks (based on Q2 2013 data). The main findings of the report were as follows:
During the past two years, capital positions have improved significantly. The Tier 1 ratio weighted average rose by more than 1 percentage point to 12.6%. Asset quality deteriorated, the ratio of impaired loans and past due loans to total loans increased by 25%, from 5.4% to 6.7%.

[8] European Systemic Risk Board

Profitability has been an ongoing concern during the past two years, the ROE weighted average has been consistently below 4% and the dispersion across the sample has been significant. Balance sheet structure is changing very slowly, the loan-to-deposit ratio has declined by more than 5 percentage points. Funding conditions have significantly improved. In summary: after two years of recovery, the overall conditions of European banks have improved, but the banking sector remains fragile given the weak and uneven recovery in the EU.

III.4 Guidelines on capital measures for FX lending to unhedged borrowers under the Supervisory Review and Evaluation Process

In December, the EBA published its final guidelines on the treatment of FX lending. The guidelines aim to promote **supervisory convergence across the EU by taking into account the relevant ESRB Recommendation.** They specify the method to be used by competent authorities when FX lending risk is deemed to be material. (FX lending risk is deemed to be material if loans denominated in foreign currency to unhedged borrowers constitute at least 10% of an institution's total loan book, where such total loan book constitutes at least 25% of the institution's total assets). Wherever FX lending risk is material, institutions should address the risk in their ICAAP and competent authorities should review the treatment of FX lending risk in the ICAAP as part of the SREP. If the treatment of FX lending risk is considered to be inadequate and existing levels of capital are considered to be insufficient to cover the risk, then competent authorities should impose appropriate measures to address these deficiencies, including requiring an institution to hold additional capital.

III.5 Other important EBA documents

Other important documents published by the EBA in Q4 included the following:

- *Final* draft Implementing Technical Standards (ITS) on supervisory reporting on forbearance and non-performing exposures.
- Two draft ITS and a draft Regulatory Technical Standard (RTS) on liquidity requirements
- Guidelines on the discount rate for variable remuneration
- Draft ITS on disclosure for leverage ratio,
- Consultation Paper on Draft Recommendation on the use of Legal Entity Identifier *(LEI).*
- Final draft implementing technical standards on asset *encumbrance* reporting
- Report on the peer review of the EBA stress testing guidelines
- Draft Regulatory Technical Standards (RTS) and final draft Regulatory Standards on own funds
- Final draft RTS on the conditions for assessing the materiality of extensions and changes of internal approaches when calculating own funds requirements for credit and operational risks,
- *Final draft* RTS on the determination of the overall exposure to a client or a group of connected clients
- Guidelines on retail *deposits* subject to different outflows for purposes of liquidity reporting,
- Follow-up review of banks' transparency in their 2012 *Pillar* 3 reports,
- Consultation on the methodology for the identification of global systemically important financial institutions,
- Warning on virtual currencies
- *Final draft* RTS on *passport* notifications,
- Final draft ITS on joint decisions on institution-specific prudential requirements,
- Draft ITS on information exchange between home and host supervisors,
- Consultation on draft guidelines on the recognition of significant risk transfer for securitisation transactions,
- Final draft RTS on securitisation retention
- Final RTS on market risk,

- Reports on the comparability and procyclicality of risk weighted assets,
- Final draft ITS on additional monitoring metrics for liquidity**,**
- Draft methodology for assessment of liquidity and funding risk under SREP
- Final draft ITS on the hypothetical capital of a *Central Counterparty,*
- Final draft ITS on supervisory disclosure,
- Technical advice on treatments of unrealised gains,
- Consultation on draft guidelines on *harmonised definitions* and templates for funding plans of credit institutions
- Report on risks and vulnerabilities in the EU banking sector,
- Final draft RTS on identification of geographical locations,
- Consultation on draft guidelines on disclosure of *encumbered* and unencumbered assets,
- Report on liquidity,
- Final draft RTS on the definition of market,
- Final draft RTS on Credit Value Adjustment (CVA).

In October, the Joint Committee of the European Supervisory Authorities published the updated list of financial conglomerates.

IV European Banking Federation

IV.1 Banking Supervision Committee

The EBF Banking Supervision Committee commented on all prudential regulatory issues and actively represented the interest of European banks. The EBF lobbies in Europe directly at the European level and internationally indirectly through the IBFed[9]. The Banking Supervision Committee's work is focused on standards related to the CRR/CRDIV and issues related to the Bank Recovery and Resolution Directive, the banking union (SSM, SRM, Deposit Guarantee Scheme Directive) and structural reforms.
Key documents published by the Committee in Q4 included the following:

- Response to EBA consultation on draft Guidelines on retail deposits subject to different outflows for purposes of liquidity reporting
- Response to the EBA consultation on prudent valuation
- Response to the EBA consultation on the method for the identification of the geographical location of the relevant credit exposures
- Response to the EBA consultation on classes of instruments that are appropriate to be used for the purposes of variable remuneration
- Response to the EBA consultation on guidelines on technical aspects of the management of interest rate risk arising from non-trading activities
- Response to FSB consultation paper on shadow banking
- Response to the Basel Committee's consultation on balancing risk sensitivity, simplicity and comparability.

In Q4, the EBF published positions on the Money Market Funds Regulation and the regulation on indices and benchmarks. It provided recommendations on prudential oversight and compiled a publication on main figures of the European banking sector.

IV.2 Payment Services Committee

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

The Payment Services Committee's operations were focused on the proposed revision of the Payment Services Directive, in particular, concerns regarding the regulation of Third Party Providers (TPPs). These service providers establish a link between the bank, the customer and the merchant. They provide account information services (as to whether there are sufficient funds in the customer's account for the transaction) as well as payment services (initiating on behalf of the customer the transfer of the amount from the customer's account), thus promoting online shopping.
During the transaction, the TPP can get hold of the customer's identification data. Consequently, the bank may not know whether it is the customer, or a TPP payment orders are received from. This raises serious security and liability issues, which the proposal has up until now failed to properly address.
Another legal philosophy issue is that the Directive is of a consumer protection character. It regulates the relationship between the customer and the service provider and does not address the relationship between the various service providers. A confusing element is that a bank may also be a TPP in certain situations. Furthermore, the fact that major internet service providers have entered the business suggests that this process should not be stopped, but rather, properly regulated. The Payment Services Committee is lobbying in the European Parliament's committees and bodies of the European Council for an early and clear-cut regulation. Although urged for by all stakeholders, the revised PSD is unlikely to be adopted until after the European Parliamentary elections.

IV.3 EBF Financial Literacy Project Group

The European Banking Federation has recognised that banks have made financial education a key element in their CSR policies. Understanding the basic financial concepts and processes is public expectation and need, mainly in view of the importance of informed consumer behaviour in an ever-changing economic environment. Accordingly, extending its Communications Committee, the EBF has set up a project working group to support the launch of the European Money Week. This educational programme is planned to be first organised in the spring of 2015, the primary target group is children and young people under 18. The initiative brings together the knowledge of financial literacy experts from 32 banking associations and some individual banks during a one-week event.