



**REPORT**

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**on Activities of the Hungarian Banking Association**  
**2nd Quarter 2014**

**Budapest, August 2014**

## Contents

<b>1. EXECUTIVE SUMMARY</b> .....	<b>4</b>
<b>2. MACROECONOMIC OUTLOOK, OPERATING ENVIRONMENT</b> .....	<b>6</b>
<b>3. CORPORATE LENDING</b> .....	<b>8</b>
FUNDING FOR GROWTH SCHEME STAGE II .....	9
CONSULTATION WITH ÉVOSZ (NATIONAL ASSOCIATION OF BUILDING CONTRACTORS) ON BANK GUARANTEES.....	9
<b>4. RETAIL LENDING</b> .....	<b>10</b>
SUPREME COURT UNIFORMITY RULING NO. 2/2014 .....	10
ACT XXXVIII OF 2014 ON THE SETTLEMENT OF CERTAIN QUESTIONS RELATED TO THE SUPREME COURT'S UNIFORMITY RULING ON FINANCIAL INSTITUTIONS' CONSUMER LOAN CONTRACTS .....	11
INCOME-BASED REPAYMENTS (PTI) .....	12
<b>5. OTHER IMPORTANT REGULATORY DEVELOPMENT AFFECTING BANKS</b> .....	<b>13</b>
BANK RESOLUTION ACT.....	13
AMENDMENTS TO THE CIVIL CODE AND RELATED LAWS.....	14
<i>Proposals regarding the Civil Code</i> .....	14
<i>Amendments to the Law Decree on savings deposits</i> .....	14
<i>Amendment to the Bankruptcy Act in the context of the new Civil Code in relation to lien priority</i> .....	14
<b>6. DEVELOPMENTS RELATED TO SUPERVISION</b> .....	<b>15</b>
FINES IMPOSED ON CREDIT INSTITUTIONS FOR PASSING ON THE FINANCIAL TRANSACTION LEVY TO CUSTOMERS .....	15
MNB DECREE, RECOMMENDATION AND DRAFT COMMUNICATION RELATED TO THE CRR/CRD IV .....	15
BENCHMARK RATES .....	15
CONSUMER PROTECTION BOOKLET.....	16
MNB DECREE ON COMPLAINT HANDLING .....	16
<b>7. PAYMENTS</b> .....	<b>16</b>
SINGLE EURO PAYMENTS AREA (SEPA) – ACTIVITIES OF THE WORKING COMMITTEE AND WORKING GROUPS.....	16
THIRD PARTY PROVIDERS (TPP) IN THE PAYMENT CHAIN.....	17
PARTICIPATION IN THE MNB'S CLS PROGRAMME – REVIEW STAGE.....	18
COOPERATION IN THE KELER WARP PROJECT – QUESTIONNAIRE SURVEY.....	18
REPRESENTATION OF THE BANKING COMMUNITY ON GIRO'S CONSULTATIVE COUNCIL .....	19
CENTRAL CUSTOMER STATEMENTS REGISTER RELATED TO THE MONTHLY TWO FREE CASH WITHDRAWALS OPTION.....	19
IMPACTS OF THE MONTHLY TWO FREE CASH WITHDRAWALS OPTION ON CONSUMER HABITS .....	19
BANK CARDS .....	20
<i>General market trends</i> .....	20
<i>Conclusion and assessment of the POS deployment project in Fejér County</i> .....	20
<b>8. TAXATION, ACCOUNTING, REPORTING</b> .....	<b>21</b>
PROPOSALS FOR AMENDMENTS TO TAX LAWS .....	21
EMPLOYER'S SUPPORT FOR MORTGAGE LOAN REPAYMENTS .....	22
PROMULGATION OF THE FATCA INTERGOVERNMENTAL AGREEMENT .....	22
ACCOUNTING ISSUES.....	22
REPORTING .....	23
<b>9. BANK SECURITY – PHYSICAL SECURITY</b> .....	<b>24</b>

DEMONSTRATIONS – DEMONSTRATION ON JUNE 20, CONSULTATIONS WITH THE POLICE, LETTER TO THE MINISTER OF INTERIOR.	24
MOBILE PHONES FOR ALARM PURPOSES.....	24
<b>10. ASSOCIATION DEVELOPMENTS.....</b>	<b>24</b>
GENERAL MEETING .....	25
EXIM SUB-WORKING GROUP ESTABLISHED .....	25
HUMAN POLICY COMMITTEE: STANDARDISING BANKING TRAINING.....	25
WORKOUT COMMITTEE .....	26
DATA PROTECTION WORKING COMMITTEE .....	26
CARDS WORKING GROUP CHAIR ELECTED .....	26
MEETING OF THE BANKING ASSOCIATIONS OF THE V6 COUNTRIES .....	26
COMMUNICATIONS.....	26
<i>Quarterly media statistics, main communication topics.....</i>	<i>26</i>
<i>European Money Week.....</i>	<i>27</i>
<b>ANNEX - INTERNATIONAL DEVELOPMENTS:</b>	
<b>REGULATION, SUPERVISION – EUROPEAN BANKING FEDERATION.....</b>	<b>28</b>

## 1. Executive summary

The slow economic pick-up seen at the global level in the previous two quarters turned into stagnation in the second quarter of 2014, while, due to the slowdown of the German economy, growth slowed further in the European Union. With good growth figures in the USA, the Fed continued to reduce its bond buying programme, while amidst growing deflationary fears in the EU, the ECB is keeping the euro benchmark rate low and intensifying its liquidity programme.

The performance of the Hungarian economy outpaced the EU average: GDP saw a surprising growth in the second quarter, increasing by 3.9% year-on-year. However, the debt-to-GDP ratio temporarily jumped as a result of the Hungarian State Treasury's increased fundraising in the international markets. Mainly as a result of the government's public works programme, the unemployment rate dropped from 10.7% in 2012 to 8% by the end of Q2 2014. The inflation rate remained around zero in the second quarter. In July, the MNB reduced its base rate to 2.1%, announcing the end of the rate-cutting cycle it started two years ago. In addition to the low interest rates, the Supreme Court's decision regarding FX loans presumably also contributed to the further weakening of the exchange rate of the forint. The exchange rate was around 315 HUF/EUR at the end of Q2.

The Supreme Court's ruling in June and the Act codifying it have basically determined the sector's second half-year performance ratios, as well. The Supreme Court's uniformity ruling declared the application of an exchange rate spread unfair. The Court also ruled that contractual provisions enabling the unilateral amendment of a contract are unfair if they do not comply with the principles laid down in point 6 of Opinion No. 2/2012 (XII. 10.) PK of the Supreme Court (the principle of clear and intelligible drafting, the principle of taxonomic definition, the principle of objectivity, the principle of factuality and proportionality, the principle of transparency, the principle of terminability and the principle of symmetry).

The Hungarian Banking Association is of the view that the Curia has gone beyond the legislative intention of the legal uniformity ruling, as did not promote the establishment of unified legal practices through the interpretation of legal provisions, but instead created a new legal norm that, in a number of places, goes in the face of effective legislation. Concerning the bid offer spread, it represented an erroneous professional position that goes against previous decisions or market practices. (In market economies the application of FX sell and buy rates, as published in the relevant banks' Announcements, qualifies as a real financial service, and banks report their relevant sell and buy rates to the National Bank of Hungary. The recognition, by the Regulator, of the bid/offer spread is also supported by the fact that from November, 2010 the lawmaker stipulated the application of the mid-rate for housing loans only, adding that the bid/offer spread had to be taken into consideration when calculating the APR). The civil legal uniformity decision represents retrospective legislation, as it sets out obligations that ignore and go beyond the stipulations of the provisions of the Civil Code and the relevant, sectoral legislation, which must also be applied to previously concluded contracts.

Act No. XXXVIII of 2014, issued in the wake of the Curia's decision, declares the application, as of May, 2014, of the bid/offer spread unfair. It also uses the presumption of unfairness in respect of all General Contracting Terms and Conditions that stipulate the option of unilateral contract amendment, and financial institutions have, in the case of FX loans, 30

days from the effective date to contest such presumption of unfairness in court, in legal actions conducted under civil law. Under the Act, any unfairly settled sums must be reimbursed to clients based on a separate Settlement Act.

Prior to the Act's publication, the Hungarian Banking Association wrote a letter to the President of Hungary, asking him to rely on his constitutional rights and initiate preliminary normative control. When the Act was passed, the Hungarian Banking Association issued a press statement, explaining that financial institutions had been providing their services in line with the effective legislation at all times, subject to the strict monitoring and approval of the lawmaker and the banking supervisory authority. The approved Act demands compliance with principles, going back a decade, which have so far not been formulated and published by either the lawmaker, the supervisory authorities or the courts. The Act rearranges the relationships that exist under private law between the banks and their clients in a retrospective manner, and overrides the general, guiding rule of 'lapsing' (the Statute of Limitation), which can have unforeseeable consequences on society.

While trying to prove in courts the fairness/legality of the provisions of their general terms and conditions enabling unilateral contract amendments, banks, based on the principle of prudence, made provisions for part of their expected losses already in the second quarter. The total amount of these provisions was nearly HUF 356 billion, which is equivalent to the pre-tax loss. As a result, the credit institutions sector lost 11% of its equity, and its capital adequacy ratio as calculated under the new capital adequacy rules fell by 2.1 percentage points to 17.4%. Aggregate total assets shrank by 2.3%, despite the deterioration of the HUF exchange rate, while the gross stock of loans remained at the level it was at the beginning of the year.

The on-going review of savings co-operatives poses additional risk to banks. The deposit-holders of co-operatives excluded from the integration scheme by the Integration Organisation of Co-Operative Credit Institutions must be reimbursed by the National Deposit Insurance Fund, whose fees, in turn, are mainly contributed by commercial banks. Due to the compensation, the assets of OBA are reducing to well below expected levels, and therefore it is quite likely that additional financial contribution will be requested, which, together with the Resolution Fund to be set up later this year, imposes additional burden on the sector. In the context of the implementation of the revised deposit insurance directive in Hungary, the Hungarian Banking Association has initiated the rethinking of the relationship between OBA and the integration scheme.

The stock of SME loans rose by 0.5% year-on-year. According to MNB statistics as of June 27, banks disbursed HUF 183.7 billion in SME loans in Stage II of the Funding for Growth Scheme. As a positive development, 98% of the HUF 223.4 billion total stock of contracts in were new loans. 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 4.66%.

As a key development, at its extraordinary summer session, Parliament adopted Act XXXVII on the further development of the institutional system promoting the security of certain actors of the financial intermediary system. This Act is aimed at the partial adoption of the EU BRRD. The BRRD and likewise, the Hungarian law introduces the institution of bail-in. This means the involvement of shareholders and creditors in the resolution, with a strong limitation

of ownership rights. Until now, it was unprecedented in Hungarian legislation for an EU Directive – which is disadvantageous for the investors - to be adopted in national law long before its entry into force.

The operations of credit institutions and financial enterprises engaged in lending will also be largely determined by the central bank's proposed regulation on Payment-to-Income (PTI) and Loan-to-Value (LTV) limits. These are aimed to replace Government Decree No. 361/2009 on circumspect retail lending, but centrally imposed strict PTI limits can set back a slowly recovering lending already in the short-term.

The MNB, in its supervisory role, continued to fine banks for passing on the Financial Transaction Levy to customers and for illegally changing their commissions and fees. However, the fines were far less in size than those imposed in March. (Several banks had filed lawsuits against those resolutions). In its consumer protection role, the MNB has updated its decree on complaint handling and plans to issue consumer protection information booklets. The Association reviewed and commented on the proposed booklets.

The capital requirements regulation and directive, CRR/CRD IV, give national authorities the discretion in several points to adopt transitional and supplementary rules until the full entry into force of the new capital and liquidity framework. In Hungary, this power is assigned to the MNB, which issues the relevant rules in the form of decrees, recommendations, or communications.

Although the dissolution of the Hungarian SEPA Association was not concluded in the second quarter, the Association has taken over the Hungarian SEPA Association's responsibilities and our working groups addressing the various areas of SEPA are in full operation. Also in the area of payments, the Association requested a ruling from the MNB on Third Party Providers. We were involved in the review stage of the MNB's CLS programme, and KELER's WARP project and appointed members to GIRO's consultative council. In cooperation with BISZ, we gave special attention to the establishment of the central register for customer statements related to the monthly two free cash withdrawals option.

In 2014, the global regulators give top priority to the completion of reforms agreed in the wake of the crisis. In relation to ending too-big-to-fail, key tasks include a common agreement on the gone-concern loss-absorbing capacity of global systemically important financial institutions, effective cross-border resolution actions, including temporary stays on close-out and cross-default rights in financial contracts, and effective bail-in a cross-border context. Remaining steps in the reform include transforming shadow banking into transparent and resilient market-based financing and making derivatives markets safer.

With a focus on the EU banking union, preparations for the Single Supervisory Mechanism continued, including the development of the relevant ECB organisation and its operating rules and staffing and the carrying out of the comprehensive assessment exercise. Before its dissolution for elections, the European Parliament adopted the Bank Resolution and Recovery Directive and the Regulation on a Single Resolution Mechanism. The only step that remains for the new parliamentary cycle is the structural reform of the banking sector. The European Banking Federation does not support the European Commission's relevant proposal.

## **2. Macroeconomic outlook, operating environment**

The slow economic pick-up seen at the global level in the previous two quarters turned into *stagnation* in the second quarter of 2014. Although economic performance improved in the U.S. and the Eastern emerging economies, **growth slowed further in the European Union** due to a sluggish external business environment, a strong euro hindering exports and a persistent decline in corporate lending. The slow in the European Union was primarily due to the slowdown of the German economy (until now the main driver of growth in the EU), falling by 0.2% in the second quarter, although analysts say that with the outstandingly high Q1 performance, this decline will only temporarily deteriorate the good growth figures.

In view of the good growth figures, the Fed is progressively cutting its bond-buying programme to stop the further growth of dollar liquidity and prevent the U.S. economy from overheating. At the same time, while deflationary fears have increasingly come to the forefront due to the low inflation in the EU, in view of the slow economic pick-up, the ECB is keeping the euro benchmark rate low and intensifying its liquidity programme.

Invariably, the risks to global growth primarily stem from geopolitical crises, in particular, Russia's policy towards Ukraine, the sanctions imposed by the U.S. and the EU and Russia's response measures may particularly adversely impact growth.

As for *Hungary's* performance in terms of vulnerability indices in the second quarter, external equilibrium continued to be good. In a favourable domestic interest rate and yield environment, the Hungarian State Treasury increased fundraising in the international markets to replace expiring short-term debts with cheaper ones. As a result, the *debt-to-GDP ratio temporarily jumped*. Due to the election year, budget expenditures rose, the funds for which were provided for by the government by consuming the reserves. This, however, did not jeopardise the low inflation objective: ministry budgets were blocked during the summer.

The Hungarian economy saw a *surprising growth in the second quarter*, surpassing the outstanding growth figures of the first quarter (*GDP grew by 3.9% in Q2 vs. 3.5% in Q1*). As a result, analysts agree that despite the expected slowdown in the second half of the year, the average GDP growth rate may be as high as 3% on an annual basis. On the production side, manufacturing and construction were the main drivers of growth, also supported by the agricultural industry. In manufacturing, the increase in car industry and subcontractor capacities was the main source of growth. However, it should be noted here that the planned capacity expansion projects have by and large been completed, therefore, the car industry cannot be not expected to continue to contribute with any additional extra performance to growth. A favourable development on the consumption side is the significant growth in exports, despite the weak performance of the German economy. Household and public consumption also contributed to growth, making it more balanced. An additional risk, in addition to weak EU markets, is the impact on the Hungarian industry and agriculture of the EU sanctions against Russia, while on the other hand, the extra potential in domestic demand may be a prop.

Mainly as a result of government measures, in particular, the public works programme, the unemployment rate dropped from 10.7% in 2012 to 8% by the end of Q2, 2014 and is expected to be between an average 8% and 8.2% on an annual basis.

*The inflation rate remained around zero* in the second quarter, so, the annual inflation rate is expected at 0.1%. The Russian food ban is a downside inflation risk. It may push prices down in the EU, and so in Hungary. Since the inflation rate is not expected to hit the target anytime

soon (the 3% inflation target is not expected to be met before 2016), the MNB may keep its base rate at the current 2.1% until the end of the next year (unless a potential weakening of the forint causes an instability risk).

With good inflation figures, the MNB continued its rate-cutting cycle, reducing the *base rate* to 2.3% by June 2014. With no more room remaining for further cuts, the rate cutting-cycle was ended with the MNB cutting the rate to **2.1%** in July. Interbank benchmark rates and banks' deposit and lending rates fell in step with the base rate cuts. Presumably, the Supreme Court's decision regarding FX loans and subsequent government measures also contributed to the *further weakening of the forint* over the previous quarter. The exchange rate was around **315 HUF/EUR** at the end of Q2.

The financial position of the *credit institutions sector* was primarily influenced by the March ruling of the Constitutional Court, the Supreme Court's uniformity ruling in June and the Act codifying it in July. Based on the principle of prudence, major banks already in the second quarter made provisions for future losses from refunds to be made due to the application of an exchange rate spread, ruled by the Supreme Court as unfair, and for those to be made due to unilateral fee increases, also expected to be declared as unfair. The total amount of these provisions was nearly HUF 356 billion, which is equivalent to the pre-tax loss. As a result, the credit institutions sector lost 11% of its equity, and its capital adequacy ratio as calculated under the new capital adequacy rules fell by 2.1 percentage points to 17.4%.

The weakening of the forint in the second quarter could not offset the 2.3% erosion of total assets, breaking the slightly improving trend seen in the first quarter. This contraction was primarily due to the decrease in interbank deposits, while gross loans remained at the level they were at the beginning of the year. (Here, loans to non-financial companies rose by 1%, loans to households fell by 1.1% over the previous quarter). The proportion of past due loans improved slightly, falling in both the corporate and retail sectors (from 23.3% to 23% and from 32.9% to 32%, respectively). The same goes for the proportion of loans past due for more than 90 days (falling from 16.9% to 16.8% in the corporate sector and from 18.5% to 18.4% in the retail sector). However, these proportions are still high by international comparison. On the liabilities side, the withdrawal of foreign funds continued (-6%), in addition to deleveraging. Corporate and retail deposits fell by slightly more than one percent.

Apart from provisioning, the second quarter saw a minor improvement in net interest income (dwarfed by the losses). The extra profits realised from the sale of securities held for investment did not have a bearing on the losses sustained. As a result of these effects, the sector's annualised H1 ROA and ROE were -1.9% and -17.3%, respectively.

### **3. Corporate lending**

According to MNB statistics, the decline in the total stock of corporate loans slowed from the 3%-4% of previous years to 1.3% in Q1 2014. The MNB's Funding for Growth Scheme supported lending with new contracts to a value of HUF 66 billion. Together with Stage I of the Scheme, this contributed to a 0.5 percent rise in SME lending, according to estimates based on transactions.

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 4.66% by June 2014. 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 17.3% in Q3 to 16.4% at the end of 2013.

However, the lending outlook is not encouraging, lending terms and conditions are expected to further tighten in the coming months. This is primarily attributable to the economic outlook and the specific challenges of the industry and less to the weakening of banks' lending capacity: banks would now be able to lend, but there is no demand in the market. As a result of the Funding for Growth Scheme, the MNB adjusted its corporate lending forecast for 2014: overall, corporate loans are expected to decline by 1.3% in 2014. The MNB expects corporate loans to grow in 2015.

### ***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. Stage II of the Scheme lasts from October 1, 2013 to the end of 2014, with two exceptions: refinancing loans for investment loans taken under Stage I can be drawn until June 30, 2015, refinancing loans for factoring can be drawn until December 5, 2017. The initial 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 and a maximum maturity of 10 years. Financing banks can relend the central bank funds to SMEs in the form of loan, financial leasing or factoring facilities at a maximum interest margin of 2.5%. Banks can also use the facility to refinance financial enterprises.

90% of the total scheme allocation is for new loans under Pillar I, 10% is for replacement loans under Pillar II. As opposed to Stage I, allocations under Stage II are awarded on a first-come-first-served basis. The combined lower limit for SME loans (the total amount of loans taken in Stage I and Stage II) is HUF 3 million, the upper limit is HUF 10 million

The preferential central bank funding made available under the Funding for Growth Scheme reduces SME financing costs and allows the implementation of projects that previously could not be launched due to high financing costs. 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.

According to MNB statistics, the total value of contracts reported in Stage II as of June 27, 2014 was more than HUF 223.4 billion, including HUF 183.7 billion in SME loans. 98% of the HUF 223.4 billion total stock of contracts were new loans. In new loans, 61% were investment loans and leasing facilities, 21% working capital loans and 16% EU grant prefinancing loans. Nearly 67% of all loans under Stage II were used for replacing HUF loans and 33% for replacing FX loans. The average loan amount was HUF 24 for new investment loans, HUF 56 million for new working capital loans and HUF 37 million for EU grant prefinancing loans.

### ***Consultation with ÉVOSZ (National Association of Building Contractors) on bank guarantees***

The Performance Certification Agency (TSZSZ) was established in 2013 to provide expert opinions in disputes related to contractual performance. These opinions play an important role

in preventing the fraudulent drawing of bank guarantees. In this context, ÉVOSZ (National Association of Building Contractors) initiated a consultation with TSZSZ and the Hungarian Banking Association. At the consultation, it was mentioned that the experience of the first year of operation of TSZSZ was positive, although the volume of debts to subcontractors remained high (but did not grow). Debts to subcontractors were still around HUF 400 billion in the construction industry.

Representatives from the Hungarian Banking Association emphasised the importance of the parties understanding the procedures and deadlines of TSZSZ (for example, the duration of suspension of payments), which are normally also included in the texts of their bank guarantees. The potential excessive power of the client does not preclude the contractor from turning to TSZSZ, since the relevant law provides for this option even where the contract and/or the guarantee restricts or excludes this right. TSZSZ informed that it can certify within three working days that it has been approached by the contractor applying for a guarantee and it can make a decision on the acceptance of the request within 20 calendar days. Any need for supplementary documents to be submitted by the applicant is also notified to the bank. Since this may be worth to be incorporated in the texts of banks' sample guarantees, we sent the memo on the meeting to all members involved.

#### **4. Retail lending**

*According to the MNB' June 2014 report on Trends in Lending: "Within the credit institution sector as a whole, outstanding household loans declined further, continuing the trend of previous quarters, with the balance of disbursements and repayments amounting to a HUF 100 billion reduction in loans outstanding. Accordingly, the annual rate of decline was similar to the previous quarter, changing from 5.2 to 5 per cent. The fall in lending resulted almost entirely from the decline in outstanding foreign currency loans. New lending to households within the overall credit institution sector amounted to HUF 96 billion in Q1, which was 27 percent higher in year-on-year terms, but was somewhat lower compared to the previous period. The findings of the lending survey revealed that banks further eased conditions on consumer credit while leaving those on housing loans unchanged. The annual percentage rate (APR) charged on new housing loans continued to fall, in line with the central bank's policy rate cuts. Responses to the lending survey reveal a pick-up in demand for consumer credit and housing loans, with the majority of banks expecting a further upswing in demand looking ahead".*

#### ***Supreme Court uniformity ruling No. 2/2014***

The Supreme Court published in advance the questions to be assessed under its uniformity procedure. The banking sector developed an opinion on the principle question related to the transparency of conditions serving as a basis for unilateral contract amendments and we sent the relevant working document to the Supreme Court's Civil Department.

On June 16, 2014, the Supreme Court published the operative part of its uniformity ruling No. 2/2014, taking position on three main issues. According to the ruling, it is not unfair to expect borrowers to assume the risk of unfavourable exchange rate movements. This issue forms part of the main subject matter of the contract, therefore, as a main rule, its unfairness is exempt from assessment. Contractual provisions enabling the unilateral amendment of a contract are unfair if they do not comply with the principles laid down in point 6 of Opinion No. 2/2012 (XII. 10.) PK of the Supreme Court (the principle of clear and intelligible drafting, the

principle of taxonomic definition, the principle of objectivity, the principle of factuality and proportionality, the principle of transparency, the principle of terminability and the principle of symmetry). Contractual clauses defining the criteria of unilateral contract amendment are fair if they clearly and intelligibly define how and to what extent changes in the circumstances of the listed causes affect the consumer's payment obligations and if they make it possible to verify the unilateral amendments' compliance with the principles of proportionality, factuality and symmetry. As for the application of an exchange rate spread, the Supreme Court ruled that it was unfair because the financial institution did not provide any service directly to the consumer. The buying and selling rates applied in foreign exchange loan contracts as rates of conversion shall be replaced by the official foreign exchange rate of the MNB. The full text of the uniformity ruling was published in the July 3, 2014 edition of Magyar Közlöny.

The Association's Board and its Litigations Working Group discussed the uniformity ruling in detail. In our opinion, in this ruling, the Supreme Court overstepped the statutory role of uniformity decisions and rather than helping the development of a uniform case-law by interpreting the laws, it created new legal norms that in a number of points contravene existing laws. In addition, in respect of the exchange rate spread, it took a position that is contrary to previous rulings as well as to the market practice, and is professionally flawed. (In market economies the application of FX sell and buy rates, as published in the relevant banks' Announcements, qualifies as a real financial service, and banks report their relevant sell and buy rates to the National Bank of Hungary. The recognition, by the Regulator, of the bid/offer spread is also supported by the fact that from November, 2010 the lawmaker stipulated the application of the mid-rate for housing loans only, adding that the bid/offer spread had to be taken into consideration when calculating the APR). (In market economies the application of FX sell and buy rates, as published in the relevant banks' Announcements, qualifies as a real financial service, and banks report their relevant sell and buy rates to the National Bank of Hungary. The recognition, by the Regulator, of the bid/offer spread is also supported by the fact that from November, 2010 the lawmaker stipulated the application of the mid-rate for housing loans only, adding that the bid/offer spread had to be taken into consideration when calculating the APR). This uniformity ruling amounts to retrospective legislation by ignoring the relevant provisions of sector laws and establishing obligations beyond those provisions, to also be applied to existing contracts.

### ***Act XXXVIII of 2014 on the settlement of certain questions related to the Supreme Court's uniformity ruling on financial institutions' consumer loan contracts***

In the wake of the Supreme Court's uniformity ruling, Parliament enacted with unprecedented speed a law on the settlement of certain questions related to the Supreme Court's uniformity ruling on financial institutions' consumer loan contracts. Submitted by the government, the law was adopted with one vote against and a few abstentions, on July 4. During the extremely short discussion in Parliament (between June 27 and July 4), the Association initiated with the Minister for National Economy that the Act should not extend to those who had participated in the Early Repayment Scheme, and expressed its disagreement to overriding the general limitation period rules. Before the promulgation of the Act, the Association turned in a letter to the President of the Republic, asking him to use his constitutional powers and request a constitutional review of the Act. In our letter, we presented in detail our constitutional concerns, stressing that it was not the intention to delay the resolution of the FX debtors' issue, since even the Act itself refers the settlement to another law to be adopted at a later stage. The President did not initiate a constitutional review and the Act was published in Magyar Közlöny on June 18.

The scope of the Act extends to foreign currency-denominated loan and financial leasing contracts and similar contracts denominated in HUF, except for those involved in the Early Repayment Scheme and those whose homes were purchased by the National Asset Management Company.

The Act provides a number of obligations for banks: the recalculations related to the exchange rate spread should be completed within 90 days (while the settlement with customers will be regulated by a separate Act); the method of recalculation must be reported to the MNB within 60 days; within 30 days from entry into force of the Act, banks are required to submit an itemised account on the contracts to the MNB.

Banks may file civil lawsuits against the assumption of unfairness, within 30 days from entry into force of the legislation in the case of foreign currency-denominated loan contracts and within 90 to 120 days in the case forint-denominated loan contracts. As for the date of entry into force of the Act, a ruling had to be obtained from the National Judicial Office, since this could not be unambiguously established from the language of the Act.

Foreclosure proceedings are suspended from the date of entry into force of the Act until a date to be determined by law at a later date.

The Association initiated negotiations with the government on the Act. During the talks with the Ministry of Justice, we requested the recognition and counting in of all previous allowances provided to customers. According to information from the Ministry, the recognition of other debtor rescue instruments is expected to be included in the Act to regulate settlements. Issues related to consistent regulation, the settlement methodology and the time limit for the MNB's procedure were also addressed.

The Litigations Working Group held several meetings on a weekly basis to review interpretation and implementation issues. Implementation issues were also reviewed with the Workout Working Group.

### ***Income-based repayments (PTI)***

The MNB's unit responsible for macroprudential regulation presented to specialists from banks and the Association its concept for the introduction of Payment-to-Income (PTI) and Loan-to-Value (LTV) limits to replace Government Decree 361/2009.

At the expert and senior-level consultations with the MNB, as well as in letters to the central bank, the banking sector in general supported the regulatory concept. However, we provided a number of objections regarding the proposed detailed rules. Most of our objections were related to the proposed PTI limits (50% for net incomes under HUF 400,000 and 60% for net incomes over HUF 400,000), the negative impacts on lending and the difficult rules for income certificates, different from banks' current practice. We emphasised that the introduction of this regulation without making Central Credit Bureau inquiries mandatory will not achieve the purpose. To mitigate the impacts, the Association proposed that the PTI limits should be introduced in several steps by product group and the unnecessarily short implementation deadlines extended. Except for the relaxation of the rules for income certificates and the making of Central Credit Bureau inquiries mandatory, the MNB did not support the Association's proposals. In relation to the Central Credit Bureau, it said that although it supported the proposal, it did not have the mandate to make inquiries mandatory. It proposed further consultations with the involvement of the Ministry for National Economy and the Ministry of Justice.

The MNB submitted its proposals to the ECB for review, with no substantive changes, at the end of May. In its opinion sent in late June, the ECB welcomed the regulatory concept and made no objections to the detailed rules.

During the subsequent consultations, the MNB was receptive to our proposals concerning the practical implementation of the regulation, while invariably rejecting our principle objections to the introduction of the PTI limit.

## **5. Other important regulatory development affecting banks**

### ***Bank Resolution Act***

At its extraordinary summer session, the Parliament adopted Act XXXVII on the further development of the institutional system promoting the security of certain actors of the financial intermediary system. This Act is aimed at the partial adoption of the EU BRRD. The government was unusually fast in transposing the BRRD: only the draft of the BRRD was available at the start of implementation of the Act. The enactment of the Act came even faster than expected by the EU; the BRRD, which was adopted in the meantime, sets January 2015 and January 2016 as the deadlines for transposition of the Directive into national law, whereas the provisions of the Hungarian legislation take effect three and sixty days after the promulgation of the Act.

The Act is a key element of the regulatory response to the financial crisis. It aims to provide a framework for the rescue of troubled financial institutions by restructuring and retaining its operable units and avoiding liquidation with the help of private funding, sparing the state from having to bail-out the institution from public funds. The BRRD is aimed to converge and harmonise laws, therefore, it is hard to understand why it was necessary to pre-empt the EU regulation. The cross-border operation of individual credit institutions and groups would have required that the framework is introduced globally, but at least at the EU level, in a coordinated matter.

The BRRD and likewise, the Hungarian law introduces the institution of bail-in. This means the involvement of shareholders and creditors in the resolution, with a strong limitation of ownership right. In other words, the shareholders and creditors of the troubled institution are forced to bear the losses incurred from the write-off of their shares and the conversion of their claims into capital. The resolution should be carried out rapidly, under the rule of law, with judicial control and appropriate legal remedy opportunities. On the state's side, the process is launched and supervised by the resolution authority. In Hungary, the function of resolution authority has been vested to the MNB, further expanding the MNB's role. However, the legislation fails to clearly define the relationship between the various functions of the MNB or the relationship between its various potential measures (ordinary and special supervisory measures, resolution authority measures). In addition, the Act formulates the possibility of imposing a resolution in a broad and uncertain manner.

During the unwarrantedly short consultation compared to the importance of this Act, we provided a number of comments regarding the contents, the lack of elaborateness and the inconsistencies of the Act with the BRRD. We drew attention to the absence of adequate judicial control and the conflicts of certain MNB powers, but without result. We failed to achieve that the banking industry's advocacy organisation is given at least one seat on the Board of the Resolution Fund (which all credit institutions are required to join and pay a

contribution to, as is the case with the National Deposit Insurance Fund and the Investor Protection Fund).

### ***Amendments to the Civil Code and related laws***

#### *Proposals regarding the Civil Code*

We requested rulings from the Justice Ministry on several issues, such as consumer lien contracts and the EUR 40 lump sum collection fee. Consultations are in process for clarifications on a number of issues, such as security deposit, the rules for guarantees, fiduciary asset management, legal representation and the right to representation.

We will propose amendments to the Ministry of Administration and Justice Decree on collateral register (Decree No. 18/2014. (III.13.)) in relation to individual and joint representation rights and system response messages.

#### *Amendments to the Law Decree on savings deposits*

Pursuant to Law Decree No. 2 of 1989, no lien can be established on savings deposits. The rules for savings deposits are to be applied to funds placed by natural persons with credit institutions under payment account and deposit account contracts, therefore, no lien can be established on these, either. In view of the fact that the new. Since under the new Civil Code security deposits are subject to the rules on lien, the prohibition of the establishment of lien would have meant the prohibition of the establishment of a security deposits. To avoid this, we initiated with the competent ministries, the Ministry for National Economy and the Ministry of Justice, an amendment to the Law Decree. The amendment was adopted by Parliament under Act XXV of 2014.

#### *Amendment to the Bankruptcy Act in the context of the new Civil Code in relation to lien priority*

The Bankruptcy Act's provision on lien priority in liquidation proceedings had to be amended due to changes in the Civil Code's regulations on lien. However, the text of the amended provision may give rise to misunderstanding. The replacement of floating charge with lien on pledged assets identified by detailed description where the lien registered in the collateral register extends to all assets of the debtor was in our opinion updated to Section 57 of the Bankruptcy Act imprecisely, or at least in a way that may give rise to misunderstanding. In response to our submission, the Ministry of Administration and Justice said that it had not been the intention to make any changes to the lien priority and agreed that further discussions were needed to provide for a common interpretation. We proposed that the text of the legislation should be made more specific to avoid any interpretation disputes. In relation to the new Civil Code, the provisions on security deposits in the Bankruptcy Act also need to be made more specific.

In addition to the above, we also submitted proposals to the Justice Ministry for the reduction of foreclosure costs, primarily by amending Justice Ministry Decree No. 14/1994. (IX.8.) on Bailiff Fees (to reduce collection commissions, narrow the scope, reduce expenses not included in the service fee). In addition, we made proposals for amendments to the Act on Judicial Foreclosure (to reduce the chamber lump sum cost, reinstate the institution of preliminary procedure, etc.)

## 6. Developments related to supervision

### ***Fines imposed on credit institutions for passing on the Financial Transaction Levy to customers***

Under new consumer protection investigations, the MNB checked on whether the unilateral changes made by market players to their fees, commissions and charges were in line with the relevant laws. After the fines imposed for illegal changes on 35 financial institutions to a total value of HUF 1.2 billion in March, the MNB in April fined an additional ten financial institutions for illegal changes to a total value of HUF 71.75 million. Institutions found in breach were required to refund the illegally collected fees. One type of reason for these fines was that previously free, 0 forint transactions were made payable, which, according to the MNB, meant the introduction of a new fee, which is prohibited. This position of the MNB is contrary to an earlier ruling by PSZÁF, but because the MNB is not a legal successor of PSZÁF, it does not consider the ruling of PSZÁF binding.

Major banks challenged the resolution on the fines in court. At the request of banks, the court suspended the implementation of the reimbursement obligation, since if banks win the case, it would be difficult to make customers repay the fees reimbursed to them based on a resolution that has been found illegal.

### ***MNB decree, recommendation and draft communication related to the CRR/CRD IV***

The capital requirements regulation and directive, CRR/CRD IV, give national authorities the discretion in several points to adopt transitional rules until the full entry into force of the new capital and liquidity framework. Accordingly, in April, the MNB Governor issued a ***decree on capital requirements, unrealised profit and loss valued at fair value, related deductions and acquired rights related to capital instruments***. (The Association had provided comments on the draft decree).

Then, the MNB sent for review its proposed ***communication on certain provisions of the CRR on national options and discretions of general relevance***. In relation to national discretions, the MNB sought to retain the previous regulation. The Association supported this objective. We supported the proposal that on important regulatory issues such as national exemptions from the large exposures rules, or the interpretation of significant delay in the context of default, the MNB should issue a decree rather than a communication, which has no legal force.

Following the European Banking Authority (EBA) recommendation of December 2013, issued based on Article 421 of the CRR, the MNB in April 2014 published for consultation its draft recommendation on ***liquidity outflows related to retail deposits***. This was basically identical with the EBA recommendation, but in certain points it provided stricter requirements. We requested that the provisions in question be aligned with the EBA recommendation. We also drew attention to some points where the definitions were inconsistent with current Hungarian laws on reporting and liquidity. In addition, we highlighted some inaccuracies in the translation of the CRR. The MNB issued the final recommendation with significantly simplified contents in June.

### ***Benchmark rates***

The parties involved (the MNB, the Hungarian Banking Association and the Hungarian Forex Association) signed the cooperation agreement on benchmark rate-setting in June. In accordance with the agreement, the Hungarian Forex Association set up a Rate-Setting Committee. The MNB and the Association appointed members to the Committee. At its first meeting on July 10, the Rate-Setting Committee defined its meeting schedule, appointed committee members to draft the Committee's rules of procedure and set the relevant deadline.

### ***Consumer protection booklet***

With the merger of PSZÁF into the MNB, the management of consumer protection was reorganised. A new unit, the MNB Financial Consumer Protection Centre was established. The Consumer Protection Centre aims to give special emphasis to consumer information. To achieve this, it is launching a publication series entitled "*Financial Navigator Booklets*" to be made available to customers at bank branches and on the MNB's website. The first six booklets (also sent to the Association for review) address issues related to borrowing ("What should I do in case of payment difficulties?"; "On the risk of indebtedness") as well as issues related to complaint handling and the credit bureau. During the review, we provided a number of interpretation and tweaking proposals and proposed that the publication should be postponed in view of some expected regulatory changes. According to information from the MNB, most of our proposals were accepted and the booklets will be issued in the autumn.

### ***MNB Decree on complaint handling***

The new decree contains no significant changes compared to the former PSZÁF decree. In commenting on the draft, we drew attention to environmental awareness aspects – and successfully: the provisions that would have required service providers to unnecessarily send a several-page form to the complainant were omitted, so, in case of rejection, the customer will only have to be notified on the forums he can turn to (a court, the Financial Arbitration Board, the MNB Financial Consumer Protection Centre) and the forms instituted by these bodies will only have to be sent (free of charge) if so requested by the customer.

## **7. Payments**

### ***Single Euro Payments Area (SEPA) – Activities of the Working Committee and Working Groups***

At its meeting, the SEPA Working Committee reviewed issues related to the dissolution of the Hungarian SEPA Association and the proposals for the renewal of the European Payments Council's (EPC) organisation, and heard reports of the working groups on their activities.

The Chair of the Working Committee reported that the liquidator had convened an extraordinary general meeting of the Hungarian SEPA Association and met the Budapest Court's request for additional information/documents and submitted the Statutes as revised accordingly.

In relation to the EPC's organisational changes, the Working Committee authorised Hungary's representative on the EPC:



- to support the extension of the term of office of the current Chair of the EPC, **Javier Santamaria**, until the end of this year, and in respect of the two candidates for Vice-Chair, support **Ms Narinda You**,
- not to support the proposed new, two-module organisational set-up of the EPC and its financing, because in the Working Committee's opinion a two-module structure would mean excessive staff and costs. (Namely, the Scheme Management Board (Module I) would have a staff of 25, while Module II, the unit carrying on the operations of the EPC's working organisation, including the Secretariat (supporting both units), the General Assembly and the Board (also governing both units) would have an additional staff of 25).

At the same time, the Working Committee took note of the EPC's funding principles, according to which membership in the Schemes would be subject to a membership fee. In addition to Scheme membership fees, participation in Module II and in the EPC's organisation would each be subject to an additional fee. Despite the fact that currently we pay a single membership fee, it seems that the total membership fee payable under the proposed three-fee system would be lower than what we pay currently.

The Working Committee heard and adopted:

- The ***XML Account Statements Working Group's Timetable***, whose first stage is a workshop on the standard, followed by the presentation of the standard, first to the working group members' banks, at the end of the summer, then to the banking community in mid-autumn and finally, to a wide range of suppliers and users at the end of the autumn;
- The two ***SEPA Payment Schemes Working Groups'*** reports on 2014 activities: the first working group addressed issues submitted for consultation by the EPC. The WG submitted an opinion to the EPC (including the comments received from each participant in the SEPA Credit Transfer (SCT) Scheme). The working group also provided comments on the proposed SCT re-call message version in the case of fraud and the proposed changes to SCT Rulebook Version 8. The second working group reviewed the issue of further developing the customer-to-bank standard, also with regard to the MNB's plan to transpose GIRO's overnight clearing to the IG2 platform.
- The National Adherence Support Group's (***NASO***) report on activities, including the implementation of tasks related to the MNB's and the Hungarian State Treasury's (MÁK) joining the SCT Scheme on September 8, 2014. The NASO obtained the required documents from the EPC, sent them to MNB and MÁK and provided MNB and MÁK assistance in answering the infrastructure-related and legal questions related to the operation of the scheme and in submitting the adherence packages.

### ***Third Party Providers (TPP) in the payment chain***

Several members bank reported that in the case of some Internet bank customers, a third party provider<sup>1</sup> (TPP) was included in the payment chain between the bank and its customer (i.e., the payer) during their online shopping transaction.

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<sup>1</sup> The user of TPP services does not have to register with the TPP or create a virtual bank account (e-wallet). When, during online shopping, the customer chooses the payment method offered by the web store and provided by the TPP, he is automatically redirected to the TPP's payment page. This automatically picks up all data of the transfer, thus, the customer will only have to select his bank and enter his online banking identifiers and then authorise the payment by using the one-time authorisation code provided by his bank. The customer's bank notifies the authorisation to the TPP and the TPP notifies the merchant, who can then promptly process the order.

According to the findings of the IT Security, Payments, Card and SEPA Working Groups, the appearance of TPPs in the payment chain creates a new situation, which involves various IT security and legal risks. In terms of IT security, a payment process of this type is a concern, because the customer provides his *identification data* to its bank (i.e., the bank managing his account and providing him with online banking services) through the TPP, which means that the TPP obtains all these data. This is a serious risk, since there is no IT security solution if the TPP mishandles or misuses the customer's identification data it has obtained. In addition, the liability and indemnification conditions will necessarily change with this new player included the payment chain.

The current regulations on payments do not provide any guidance on this situation: the ***services provided by Third Party Providers are not considered as payment services under the current payment regulations***. Complaint handling is an additional problem, as is the question of who is responsible for what in this set-up.

Since this is not a sporadic phenomenon, but content-wise a “***payment***” service that is expected to gain more ground in the future and the parties affected cannot wait for the EU to regulate the issue, the Association requested a ruling from the MNB to tackle the situation. We requested that the ruling address the practice to be followed to manage the risks between the payment service providers and the TPP, as well as those between the TPP and the customers and between the payment service provider and the customers.

The involvement of TPPs in payments – the security risk created in e-banking – requires a review of the EU Payments Directive. Since none of the IT, legal and technology proposals presented thus far have proved convincing for either of the parties involved, the EU regulators are contemplating postponing the solution. According to the current draft, the EBA would have one year after the adoption of the Directive to develop a secure standard that meets the expectations provided in the Directive and does not hinder technological development.

#### ***Participation in the MNB's CLS programme – review stage***

At the MNB's request, the Association is actively involved in the CLS programme, planned to be concluded in April 2015. This programme is aimed to connect the *forint* as a foreign exchange currency to the Continuous Linked Settlement System operated by CLS Bank. During the current, review, stage, we participated in two important steps. In late April, we organised a consultation, where representatives from CLS Bank presented the structure and operation of the system and the possible forms of connecting to and membership in the CLS system. The consultation also offered the opportunity for specialists from member banks to have bilateral discussions with CLS Banks' representatives.

In addition, we participated in the organisation and management of the questionnaire survey to assess banks' preparations, i.e., whether they have set up their project teams, provided for the funding of the required development projects and decided on the form of connection to the system.

#### ***Cooperation in the KELER WARP project – questionnaire survey***

WARP (Wide Application Order Routing Platform) is KELER's latest innovation in the Hungarian capital market. It is an instruction processing and transaction management system supporting the distribution and settlement of investment units. It aims to provide an effective

instrument for actors involved in the distribution of investment units to allow them to make their work processes simpler and more secure. The system's services extend from the registration of the distributor's instructions to the posting of the settlement to KELER's account system, the preparation of the distribution and settlement reports, balance inquiries, and automatic fee calculation for fund managers.

KELER requested assistance from the Hungarian Banking Association in the implementation of the project by ensuring the participation of banks' distributors in the consultations and by forwarding to banks the questionnaires developed for the purpose of development of the fee structure and collecting the results. The Association met both requests, successfully representing members involved.

### ***Representation of the banking community on GIRO's Consultative Council***

The MNB requested the Association to appoint members from banks to the Consultative Council operating under the auspices of GIRO Zrt. When the MNB bought banks' stakes in GIRO and acquired control rights in the company, it committed to soliciting banks' opinions on all strategic issues affecting GIRO. The Consultative Council will be the discussion forum for strategic issues. The Council will be made up of representatives from the MNB, GIRO, and senior payments specialists from banks and the Hungarian State Treasury (MÁK). The Association's Board discussed the issue and determined the aspects for the representation of banks on the Council. The list of specialists, put together accordingly, was sent to the MNB.

### ***Central customer statements register related to the monthly two free cash withdrawals option***

Although the option of monthly two free cash withdrawals has been available to customers since February 2014, the statutory deadline for establishing the related customer statements register (aimed to prevent ineligible withdrawals) is December 2014.

In the second quarter, the Association organised two consultations for BISZ Zrt., as the company responsible for the creation and management of the register, and member banks. The consultations were held with high attendance. At the consultations, BISZ presented in detail the timetable for the creation of the system, the status of authority permits, the developments required on its own part and on the banks' part the contents and of the contracts to be concluded and the relevant process. Following the initial upload in the autumn, the system will provide a so-called "consolidated" report for all banks on December 1, 2014. The consolidated report will show the bank where the payment account designated by the customer for the free cash withdrawals option is kept and help identify any ineligible account use. Representatives of the Association briefed participants on the Association's proposals for adjustments to the legislation – as consulted on and agreed with members - regarding the operation of the register. Upon our proposal, the deadline for reporting the customer statements to the register was extended. Furthermore, the change in account numbers at the same bank will not have to be reported. Account numbers will not have to be reported, either. The consultations also gave banks the opportunity to discuss with BISZ IT, legal and reporting issues related to the system.

### ***Impacts of the monthly two free cash withdrawals option on consumer habits***

The impacts of the monthly two free cash withdrawals option on consumer habits can primarily be assessed based on the MNB's data tables. These reveal that there was no significant change from the previous trends in respect of bank card transactions in Q1. There were 25.3 million cash withdrawals to a total value of HUF 1,437.8 billion. The average cash withdrawal amount rose slightly, by over HUF 2,000 compared to the previous half-year, to HUF 56,860 in Q1.

MasterCard also launched a research to assess market impacts. The survey was aimed to assess the impacts of the monthly two free cash withdrawals option on consumer habits three months after its introduction in February 2014. The results, published on June 23, 2014, reveal that the monthly two free cash withdrawals option had no significant impact on consumers' payment habits. The trends balanced out: six out of ten consumers used the same amounts of cash and paid by bank cards as frequently as before. Of the remaining four, two withdrew less and two more cash than before the introduction of the free withdrawals option. Overall, people did not use more cash than before, but withdrew the same amount of cash by making fewer cash withdrawals. Meanwhile, the number of those exclusively paying in cash has been falling steeply over the past years in Hungary, dropping to below ten percent by now. The research, conducted on a sample of 900 urban residents reveals that there is no need for the HUF 150,000 cap: nine out of ten people (86% of the population in major cities) do not want or cannot withdraw HUF 150,000 every month. One third of the respondents withdraw less than HUF 50,000 in cash per month, another one third less than HUF 100,000 per month. Only three percent of the respondents exhaust the cap every month.

## ***Bank cards***

### *General market trends*

On June 5, the MNB published its annual summary report on the payment system, followed by Q1 payments data tables on June 30. Figures reveal that the use of electronic payment instruments continued the slow rise seen over the previous periods. As for progress in infrastructure, the number of bank accounts, debit cards and POS terminals stagnated, while the number of contactless cards and related POS terminals increased significantly. Hungary has a podium place in contactless technology in Central and Eastern Europe. The number of payment cards declined slightly. There are 7.54 million debit cards in use, one percent less than in 2013. The number of credit cards fell by four percent to 1.32 million by the end of Q1. The number of contactless cards increased by 25%, to 2.2 million. A quarter of all payment cards are now contactless. The MNB report considers that Hungary is catching up in the use of electronic payment instruments, but the efficiency of payments still lags behind by European comparison. At the same time, the MNB recognised that the fast technical progress of mobile devices seen in recent years may also foster the development of electronic payment services. Importantly, bank card payments in Hungary are safe, the number of frauds is low, with merely five frauds per one million card transactions.

### *Conclusion and assessment of the POS deployment project in Fejér County*

In 2013, 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 and implemented with the involvement of VISA Europe, the Hungarian Banking Association and six institutions providing card acceptance services (BB, Erste, K&H, OTP, Six Payment Services and Takarékbank). The project was actively supported by the Fejér Country

Chamber of Commerce and Industry. Merchants and service providers in Fejér County can use the POS terminals at preferential terms for two years.

Payment service providers involved in the project approached thousands of merchants with favourable offers. Card acquirers deployed 114 POS terminals at merchants in Fejér County. Nearly half of the POS terminals are used by merchants with less than HUF 10 million in revenues. According to estimates, the growth in POS terminals in Fejér County during the deployment period was double the national average.

In terms of the number of terminals deployed, the results of the project fell short of the expectations of the participants. This was probably due to the combined effect of different factors arising on the merchants' and the card acquirers' part. The start of the project was delayed due to some competition law concerns that had to be clarified, thus, the deployment period coincided with the Christmas shopping season. Not all merchants were able to commit significant resources to publicising the deployment of POS terminals. Also, merchants were busy with installing their online cash registers to be connected to the Tax Authority. Some merchants were reluctant to accept bank cards, despite the fact that the POS terminals were made available at preferential fees. This may be attributable to the preference of cash payments, which are more difficult to track. Some others did accept the POS terminals, but said the costs related to bank card transactions were too high for them.

The institutions participating in the project agree that the above experiences should be used to further explore the motives of the various players and public policy measures that may contribute to promoting the use of electronic payments by retailers and small businesses.

## **8. Taxation, accounting, reporting**

### ***Proposals for amendments to tax laws***

After the parliamentary elections in the spring, we assumed that there was a package of amendments to tax laws being drafted. Hence, we submitted related proposals to the Ministry for National Economy. We requested, inter alia, that the rule on tax exemption for debt forgiveness be extended to claims arising from financial leasing contracts. We also initiated that the preferential employer's support for loan repayments be extended to include loans taken from financial enterprises. We also highlighted practical issues related to provision incorporated in the 2014 VAT legislation in relation to services provided on an ongoing basis. Our proposals made in respect of the latter two issues were incorporated in the law amendment.

We also proposed the abolishing of the Financial Transaction Levy on cash withdrawals under the monthly two free cash withdrawals option, stressing that it was unacceptable to tax a free service.

There is an increasing number of statements from EU member states cooperating on the proposed Financial Transaction Tax (FTT) indicating that an agreement is close. It is expected that the Financial Transaction Levy rules on securities and investment services may take effect in 2015. The relevant Hungarian rules (effective but not yet operative, pending the EU agreement) are different from the EU regulation taking shape and are detrimental to the sector as well as to the country. Hence, we requested the modification of the relevant rules. In relations to measures to combat the shadow economy, we pointed out that households should be incentivised to shift to cashless payment methods. Therefore, we requested that the Financial Transaction Levy is abolished for bank card payments.

### ***Employer's support for mortgage loan repayments***

Under the Personal Income Tax Act (Act CXVII. of 1995), employers may grant their employees HUF 5 million as tax free fringe benefit within five years. From January 1, 2014, this may be used for mortgage repayments. To help consistent application of the repayment support rules, the Ministry for National Economy issued Decree No. 15/2014 (IV.3). Most of the proposals to the draft were incorporated in the Decree. The implementation of the new regulation required significant IT development work and we held several consultations on the related issues. Due to the different life situations and the rulings issued in previous years, a number of questions arose. Therefore, we requested rulings from the Economy Ministry's taxation unit. We requested the Ministry to publish its response to both help interested employers and employees, many of whom had turned to us for interpretation of the regulation. The Tax Authority published a guidance on its website to ensure consistent interpretation of the regulation.

The decree regulating the implementation of the Personal Income Tax Act provided that the employer should obtain a bank certificate on the transfer of the support to the employee and the bank should send this certificate, broken down by employee, to the Tax Authority. Although the decree provides that the employer should cooperate in this with its bank, several banks indicated that employers did not really take account of the banks' aspects and transferred the supports from arbitrarily chosen accounts, in a manner which makes it impossible to keep track. This jeopardises the accuracy of banks' year-end reporting. Upon the indication of the problem by the Association's Payments Working Group, we conducted a survey, which, while revealing diverse banking practices, confirmed the reality of the problem. The Association turned to the competent authorities (the MNB, responsible for payments, and the Tax Authority, responsible for administrative reporting) for a common solution.

### ***Promulgation of the FATCA intergovernmental agreement***

On May 12, the Parliament passed the FATCA intergovernmental agreement concluded with the USA and the Act on regulatory amendments required for the implementation of the agreement. The Act entered into force on July 16. At the FATCA Working Group's meeting, we collected the issues arising in connection with the Act and the intergovernmental agreement and sent them to the Ministry for National Economy. The Ministry duly responded to the issues raised. Also, a consultation was held on the Tax Authority forms to be used by banks for the purpose of FATCA reporting.

### ***Accounting issues***

In May 2014, the the Ministry for National Economy invited another meeting on IFRS transition, to discuss issues related to vocational training and coordination with fellow authorities.

In relation to vocational training, it should be assessed whether there are enough instructors available, whether the quality of the current training courses is adequate, and whether there are enough teaching materials and technical literature available in Hungarian to ensure adequate preparations at companies and at the authorities. In Budapest, there are enough IFRS training courses, however, their quality varies. This can be improved by introducing a standard examination system. As for the provinces, there is a need for more training courses and for a forum to be established for technical dialogue, in particular on Hungarian specifics. The Hungarian translation of IFRS standards and their explanations should be updated on a

regular basis. The Hungarian translation of “Volume B”, providing illustrative examples for the introduction of the IFRS is also indispensable.

The Ministry for National Economy started consultations with fellow authorities (the MNB, The Justice Ministry, the Tax Authority and the Central Statistical Office). Through the largest auditing firms, a questionnaire was sent out to around 5,000 businesses to assess their willingness to shift to the IFRS. The auditing firms say that the responses are mostly positive. Currently there is no quantified information on how the introduction of the IFRS will affect tax revenues in Hungary. A survey conducted earlier in the Czech Republic revealed that after an increase in the short-term, tax revenues would balance out in the medium and long-term. The factors causing differences can be offset by tax base modifying items. The extra tax occurring in the year of transition can be distributed over a few years, as was the case in the U.K. In relation to the local business tax, it was raised that it will not be possible to verify its calculation based on the IFRS report, because the IFRS allows reporting on a net basis. However, this is manageable, because the tax liabilities can be established based on the detail ledgers. For credit institutions, fair value reporting will certainly result in an increase in tax liabilities, hence, this issue needs to be tackled. Specialists from member banks reiterated that the introduction of the IFRS would only make sense if it replaced HAS-based financial statements and reporting.

### ***Reporting***

In early April, we set up the FINREP Working Group to address issues related to FINREP reporting, taking effect in 2014, with the first reports due on the period ending September 30, 2014. The Working Group holds meetings according to the schedule adopted by members, normally on a three-weekly basis. The size of the reports is illustrated by the fact that the reporting package is made up of four chapters, containing more than 70 detailed templates. In The Working Group managed to clarify a number of issues and we also received responses from the MNB on a number of issues. It is general experience that any major change initially entails more tasks, primarily in relation to the interpretation of the various rules, both on the regulatory side and on the implementing side. Progress is also hindered by the fact that unlike in the case of the harmonised (but not common) prudential and financial reporting, national authorities have no mandate to issue rulings in relation to the Single Rulebook. The problem is well illustrated by the nearly 1,000 questions that have gathered on the EBA’s website, requiring rulings. Another obstacle is that the final technical aids were adopted and published very late and the regulatory decisions to be made by the national authorities were also adopted late. At the same time, it was a great help that at the request of the Association, the MNB’s competent staff members joined the work and attended our meetings.

In relation to CRR/CRD IV, we managed to ensure that the provisions of the credit Institutions Act on the disclosure of financial data are made more favourable for banks. Pursuant to the relevant amendment, institutions will only have to disclose their financial data once a year, unless the MNB as a supervisor imposes a more frequent disclosure requirement. This means that a disproportionately high administrative burden on credit institutions has been averted, which is especially important in 2014, given that there are a number of open questions that may cause uncertainty in the calculation of the data for the first half-year.

In relation to the MNB P55 monthly report, originally planned to be introduced as of July 1, 2014, at members’ request, we requested the MNB to postpone the introduction date. Namely, the original August 11 deadline for the first submission of the reports would have been unworkable due to the required IT development work and the ongoing transition to COREP

and FINREP reporting. Before finalising the reporting requirement, the MNB assessed the cost implications of the new data collection and imposed the new reporting requirement with the deadline for the first reports set as October 29.

The above new statistical data collection, providing detailed information on revenues from payment services and pricing, was developed and imposed by the MNB in view of the latest regulatory changes affecting payments (the Financial Transaction Levy, the reduction of interbank commissions, the introduction of the monthly two free cash withdrawals option).

## **9. Bank security – Physical security**

### ***Demonstrations – demonstration on June 20, consultations with the Police, letter to the Minister of Interior***

The series of demonstrations continued in the second quarter. The objectives and methods of these demonstrations, which started last summer, have changed and are now expressly aimed to make banks' operations impossible and intimidate bank branch employees. The demonstrators have become aggressive. The organisers of the demonstrations are using increasingly sophisticated methods, abusing the freedom of association.

The tone of the demonstrations growing violent is well-illustrated by the demonstration organised on June 20 on the site of the January bank explosion, carrying the slogan „Avoid another bombing”, and planned to be accompanied by sound and light effects. By a lucky circumstance (the area outside the affected bank branches is qualified as a private area open for public traffic, and the representative of the owner of the area prohibited the demonstrators from entering the area) and with exemplary cooperation between bank staff and police, the demonstration ended with no atrocities.

The Association's Human and Physical Security Working Group is working together with the Police on an ongoing basis to keep the demonstrations under control. Based on the consultations and the Police's actions at the demonstration, we have concluded that the Police has limited options. Hence, in June we wrote a letter to the Minister of Interior, requesting him to initiate legislative measures to ensure that the personal, civic and constitutional rights of bank employees and customers enjoy the same degree of protection as those of the demonstrators. The Minister's reply did not say whether or not he would take action as requested by us.

### ***Mobile phones for alarm purposes***

As a result of consultations with the National Police Headquarters, the Association will make available water and shock-resistant mobile phones to the Police's operation control centres. The rules for making available and using these phones have been agreed with the Police and the text of the cooperation agreement containing these provisions has been drafted, the Police recommendation to be attached to the agreement is now being reviewed. The text of the agreement between the Association and members regarding information exchange and the use of the phone numbers is currently being reviewed by the Human and Physical Security Working Group.

## **10. Association developments**



## ***General Meeting***

The Association held its annual general meeting on April 25. The meeting was also a festive event marking the Association's 25<sup>th</sup> Anniversary. The meeting was attended by the Minister for National Economy, Mihály Varga, and the MNB's Deputy Governors, Ádám Balog and Ferenc Gerhardt. Marking the Jubilee, the book on the history of banking advocacies in Hungary was presented, with its contents displayed on our website and published in a special edition of Pénzüntézetű Szemle (Financial Review). The general meeting adopted the Association's report on 2013 activities, the report on the Association's financial management in 2013 and the Association's 2014 budget. Elections were also held at the general meeting. The general meeting elected Mihály Patai (Chairman & CEO, UniCredit Bank) as President, András Becsei (CEO, OTP Mortgage Bank) as Vice-President, and Éva Hegedűs (Gránitbank), Jelasity Radovan (Erstebank), Roland Nátrán (Eximbank), Hendrick Scherlinck (K&H Bank) and György Zolnai (Budapest Bank) as Board members. Henrik Auth was elected as Chair of the Ethics Committee.

Association's Golden Beehive award was presented to this year's recipients:

- Dr. Iván Ferencz, Fundamenta-Lakáskassza Zrt.
- Gábor Kiss, Unicredit Bank
- Tamás Kovalovszki, K&H Bank
- Pál Kovács, OTP Bank
- Dr Iván Berár, Police Department District V
- Dr Gyözű Mészáros, Hungarian Leasing Association

## ***EXIM Sub-Working Group established***

At the initiative of Eximbank's CEO, Roland Nátrán, the Eximbank Sub-Working Group was established under the SME Working Group, with participants from 20 banks. The Sub-Working Group is charged with reviewing the products currently made available by the Hungarian Export-Import Bank and those under development. The Sub-Working Group will develop proposals to ensure that EXIMBANK's product range serves the banking sector and through it, exporters' objectives and needs, as efficiently as possible, thereby contributing to increasing lending volumes, in line with EXIMBANK's strategy and the government's economic policy objectives. The Sub-Working Group aims to promote distribution channels and will serve as a forum for proposals and information exchange.

A key activity of the working group is the review of parameters of the Exim Microcredit Programme (EXIM Card). The Programme is expected to be launched in the autumn. The relevant cooperation agreement has thus far been signed by 8 credit institutions. Under the Programme, overdrafts will be made available with a maturity of one year, for amounts between EUR 10,000 and EUR 500,000 (HUF 3 million and HUF 150 million). In addition, the working group conducted several consultations on other refinancing products. As a result of these consultations, EXIMBANK's refinancing agreements were modified based on banks' comments.

Also, representatives from EXIMBANK gave a presentation on post-financing and insurance-related issues.

## ***Human Policy Committee: Standardising banking training***

A key task for the Association's Education and Training Working Group is to formulate and set up standard training requirements that can serve as a basis for the basic training of branch

employees and new recruits. The answers to the questionnaire survey conducted on the topic were evaluated by the International Training Centre for Bankers. The results were discussed by the working group in May. It was decided that pilot projects will be conducted on two topics (training for new branch recruits and training on investment services) with a view to the development of standardised curricula. The curricula will be presented to the Board, and once approved, the drafting of the detailed methodology can commence.

### ***Workout Committee***

The Workout Committee invited the President of the National Association of Liquidators, Ferenc Somogyi to its June meeting, who gave a presentation on the latest amendments to the Bankruptcy Act and the changes affecting liquidators. The committee member responsible for claim workout was involved in the consultations conducted with the Chamber of Bailiffs and the Chamber of Notaries.

### ***Data Protection Working Committee***

At its meetings in the second quarter, the Data Protection Working Committee addressed the following issues:

- issues related to master data and group level data processing,
- data protection practices related to cookies; collective data processing, contents of consents for data processing,
- use of the employee's own devices, related data protection issues,
- data transfer for debt collection purposes, related information provision issues,
- data protection issues related to the FATCA, reporting data processing to the authorities,
- Central register of customer statements related to the monthly two free cash withdrawals option, private data processed in the register.

### ***Cards Working Group Chair elected***

In line with its rules of procedure, the Cards Working Group elected its Chair concurrently with the Association's general elections. Through a secret ballot vote, the former Chair, Zoltán Krasznai (OTP Banks) was re-elected with 100% of the votes. He received his official appointment from the Secretary-General on June 3.

### ***Meeting of the banking associations of the V6 countries***

The semi-annual meeting of the banking associations of CEE EU member states was held in Bratislava. The key themes of the meeting included the increasing importance of consumer protection in the EU and its impacts on the CEE banking sectors, new developments related to bank taxes, competition law changes, changes in the application of competition laws, and the regional impacts of the European Commission's bank structural reform proposals.

### ***Communications***

#### ***Quarterly media statistics, main communication topics***

The Association continued to receive intense attention from the media in the second quarter of 2014. We had appearances in the online media in 570 instances, followed by the print media,

in 280 instances and the electronic media, in 190 instances. In total, we had more than 1,000 appearances and mentions in the Hungarian media in Q2. Through press releases, we provided information on the Association's annual general meeting, which also marked the Association's 25<sup>th</sup> Anniversary. At the event, the book on the history of Hungarian banking advocacies, compiled through a year of research work was presented. The research has revealed, inter alia, that the first Hungarian banking advocacy was formed in 1903, preceding by nine years for example the Swiss Banking Association, which was established in 1912. We also introduced to the press the Association's new Board members.

The issue of resolving the FX lending issue continued to be a key topic. We communicated the banking community's position through interviews and statements, and a press release issued in June – responding in particular to the Supreme Court's decision and the ensuing risks.

### *European Money Week*

The European Money Week is a programme launched by the European Banking Federation to raise awareness and coordinate and communicate on actions on financial education at national and European level. The programme draws on the experience and success of initiatives implemented in some member states. The objective is to raise awareness of the importance of financial education. The EBF will support the national initiatives with specific high level events, communication (including a website) and the sharing of good practices. The 2015 EMW is planned to be held in the second week of March 2015 and will be mainly targeted at primary and secondary school students. National banking associations and banks willing to participate in the EMW should undertake to concentrate some actions on financial education during that week. The EBF will develop the framework, timing and support needed for raising international awareness, but will not define or evaluate the participant countries' programs and will not provide financing for it.

The development, finalisation and approval of the Hungarian Money Week' programme will be the responsibility of a task force team. The Association's Board supported the Association's participation in the programme and approved the setting up of the task force team.

## **INTERNATIONAL DEVELOPMENTS: REGULATION, SUPERVISION – EUROPEAN BANKING FEDERATION**

### **I. Global regulation**

#### ***I.1 Financial Stability Board (FSB)***

##### ***I.1.1 Financial reforms***

Ahead of the G20 summit in Brisbane, the FSB Chairman, Mark Carney in April wrote a letter to the G20 Ministers and Governors, summarising the progress in the implementation of the reform of the global financial system and measures required for completion of the reform, including:

- Ending too-big-to-fail,
- Transforming shadow banking into transparent and resilient market-based financing, and
- Making derivatives markets safer.

In his report, the FSB Chairman highlighted the need for an approach that goes beyond the Brisbane summit, with commitments to

- Peer reviews and impact assessments;
- Outcomes-based approaches to resolving cross-border issues; and
- Enhanced co-operation to avoid domestic measures that fragment the global system.

The letter points out that important tasks for the completion of the reform include a common agreement on the gone-concern loss-absorbing capacity (GLAC), including the criteria that bank liabilities should meet to be considered as GLAC, a common minimum GLAC standard and the determination of where in the structure of banking groups the GLAC should be held. The letter also points out that effective cross-border resolution actions, including temporary stays on close-out and cross-default rights in financial contracts, and effective bail-in in a cross-border context, are also key to the reform.

##### ***I.1.2 Report on enhanced supervision***

In the aftermath of the global financial crisis, supervisors assessed their approaches and methods and took measures to enhance supervision, particularly in respect of systemic in global systemically important financial institutions (G-SIFIs). The FSB's competent expert group has explored the tools and methods that are increasingly used by supervisors in order to intensify supervision especially when capital and liquidity are inadequate. The expert group explored:

- the interaction between supervisors and boards, senior management and control functions such as compliance and internal audit;
- the formulation of enhanced supervisory expectations for institutions' risk governance frameworks;
- ongoing focus on rigorous financial / business model analysis and other forward looking risk analysis tools such as stress testing to detect early weaknesses or problems.

The report reviews the key problem areas in supervision and the measures taken to improve them (more effective interactions with institutions, greater focus on governance, risk appetite and culture, higher expectations for risk identification and measurement, increased understanding of the business, more robust stress testing, stronger resolution planning and increased oversight of financial market infrastructures). The report concludes that notwithstanding the advancements made, more work is needed in implementing the enhancements, strengthening risk management and measurement, improving models, enhancing stress testing, strengthening resources, continuing benchmarking, assessing supervisory effectiveness and defining supervisory risk appetite.

### ***1.1.3 Framework for assessing risk culture***

The FSB published a guidance on supervisory interaction with financial institutions on risk culture. The guidance points out that culture is a very complex issue, since it involves behaviours and attitudes. A sound risk culture should emphasise throughout the institution the importance of ensuring that:

- (i) an appropriate risk-reward balance, consistent with the institution's risk appetite is achieved when taking on risks,
- (ii) an effective system of controls commensurate with the scale and complexity of the financial institution is properly put in place,
- (iii) the quality of risk models, data accuracy, capability of available tools to accurately measure risks and justifications for risk-taking can be challenged, and
- (iv) all limit breaches, deviations from established policies, and operational incidents are thoroughly followed up with proportionate disciplinary actions when necessary.

The guidance provides that supervisors should consider whether an institution's risk culture is appropriate for the scale, complexity and nature of its business and based on sound, articulated values which are carefully managed by the leadership of the financial institution. It is aimed at assisting supervisors in identifying practices, behaviours and attitudes that may influence the institution's risk culture. It also provides guidance for supervisors to assess the soundness and effectiveness of a financial institution's risk culture.

### ***1.1.4 OTC derivatives reforms***

In 2009, the G20 leaders agreed on a comprehensive reform agenda for the OTC derivatives markets. In April, the FSB published its seventh semi-annual progress report on the reforms. The report finds that substantial progress has been made toward meeting the G20 commitments: more than three-quarters of FSB member jurisdictions have regulations in place to require transactions to be reported to trade repositories. Frameworks for central clearing requirements are in place in jurisdictions with the largest derivatives markets, key international policy standards have been finalised. Work on the few remaining standards is on track to be finalised by end-2014 or earlier. These include capitalisation of banks' central

counterparty exposures, recovery and resolution of financial market infrastructures and risk mitigation standards for non-centrally cleared derivatives.

A working group from regulators from large OTC derivatives markets was set up to improve the cross-border implementation of OTC derivatives reforms. Authorities should put in place regulations flexible enough to ensure cross-border application.

In addition to the above, the FSB published the following documents in the second quarter:

- Data Gaps Initiative – A Common Data Template for Global Systemically Important Banks,
- Peer review on the FSB principles for reducing reliance on CRA ratings,
- Compensation monitoring,
- Global legal entity identifier,
- Peer review on supervisory frameworks and approaches to SIFIs (questionnaire for national supervisory authorities),
- Consultative document on foreign exchange benchmarks,
- Report on major interest rate benchmarks.

## ***1.2 Basel Committee on Banking Supervision (BCBS)***

### ***1.2.1 BIS<sup>2</sup> Annual Report (April 1, 2013 - March 31, 2014)***

The report points out that a new economic policy compass is needed to help the global economy step out of the shadow of the great financial crisis. The BIS calls for adjustments to the current policy frameworks to restore sustainable and balanced economic growth. It stresses that the only source of lasting prosperity is a stronger supply side and it is essential to move away from debt as the main engine of growth. In crisis-hit countries, there is a need to put more emphasis on balance sheet repair and structural reforms and less on monetary and fiscal stimulus. In economies that escaped the worst effects of the financial crisis and have been growing on the back of strong financial booms, there is a need to put more emphasis on curbing those booms. Special attention should be given to new sources of financial risks, linked to the rapid growth of capital markets.

The report establishes that the financial sector has gained some strength since the crisis. Banks have rebuilt capital (mainly through retained earnings) and many have shifted their business models towards traditional banking. However, despite an improvement in aggregate profitability, many banks face balance sheet weaknesses from direct exposure to over-indebted borrowers. Market-based financial intermediation has expanded, notably because banks face a higher cost of funding than some of their corporate customers. In particular, asset management companies have grown rapidly over the past few years and are now a major source of credit.

### ***1.2.2 Progress report on implementation of the Basel regulatory framework***

In April, the Basel Committee published its semi-annual report on progress in adopting Basel II, Basel 2.5 and Basel III. (The status of implementation in the various jurisdictions is summarised in a table format). In addition to the progress in implementation, the Committee also assesses regulatory consistency by country. The Committee hopes that these reports will

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<sup>2</sup> Bank for International Settlements. The Basel Committee operates under the auspices of the BIS.

contribute to transposing the internationally agreed standards into national legislation as accurately as possible.

### ***1.2.3 Supervisory guidelines for identifying and dealing with weak banks***

These draft guidelines will replace the 2002 Committee guidance on the topic. Key changes to the 2002 guidance include:

- emphasising the need for early intervention and the use of recovery and resolution tools, and updating supervisory communication policies for distressed banks;
- providing further guidance for improving supervisory processes, such as incorporating macroprudential assessments, stress testing and business model analysis, and reinforcing the importance of sound corporate governance at banks;
- highlighting the issues of liquidity shortfalls, excessive concentrations, misaligned compensation and inadequate risk management; and
- expanding guidelines for information-sharing and cooperation among relevant authorities

Early identification and intervention by supervisors is critical in preventing an escalation of problems. The revised guidelines provide an important toolkit for supervisory authorities to deal with weak banks in a timely and effective manner.

Comments on the consultative document are invited by September 19.

### ***1.2.4 Review of the Pillar 3 disclosure requirements***

The Basel Committee has long recognised the importance of effective disclosure to enhance market discipline and thereby promote a safe and sound banking system. However, the current Basel framework Pillar 3 disclosure requirements, in particular those related to risk-weighted assets (RWA), have proven to be inadequate in a number of respects. A key shortcoming has been the lack of consistency across banks, both with respect to the contents and granularity of the information disclosed. The proposed new standard promotes greater consistency in the way banks disclose information about risks, as well as their risk measurement and management. The revisions are aimed to enable market participants to compare banks' disclosures of the capital ratio's denominator (i.e., RWA) and to assess more effectively a bank's overall capital adequacy. They are also aimed to respond to concerns about the opacity of internal model-based approaches to determining RWA.

Comments on the consultative document are invited by September 26.

### ***1.2.5 Principles for effective supervisory colleges***

In June, the Basel Committee published revised principles for effective supervisory colleges. The revisions reflect the experience in applying the original principles, published in October 2010. The principles aim to promote and strengthen the operation of supervisory colleges based on best practices. The revised principles emphasise the need for greater collaboration and information-sharing on an ongoing basis (beyond occasional physical meetings) among college members. They also take account of the latest developments, such as the operation of Crisis Management Groups (CMGs) and the increased importance of macroprudential information. Key revisions include the following:

- Greater emphasis on ongoing collaboration and information-sharing,
- The need to strike a balance between core college effectiveness and host involvement,
- Home and host supervisors are expected to put in place appropriate mechanisms and sufficient resources for effective and timely two-way information exchange,

- Home and host supervisors are encouraged to agree on the types of feedback provided to banks and ensure consistency in how such feedback is provided.

Other important documents published by the Basel Committee in the second quarter:

- Capital standard for bank exposures to central counterparties
- Standard for measuring and controlling large exposures,
- Survey on securitisation markets.

## **II. European regulation**

Long-term growth and job creation, the improvement of economic, social and environmental performance are strategic objectives of the EU. While there are relatively good results in the areas of education, climate and energy policies, there is a considerable lag in meeting the goals in the areas of employment, research and the fight against poverty. The Italian presidency's programme will focus on the bank structural reform, creating, and restoring confidence in, benchmarks (reference interest rates), the regulation of money market funds and the strengthening of the framework for long-term financing. Other focus areas of the Italian presidency include taxation (extending the automatic exchange of information, agreement on a Financial Transaction Tax, standard VAT returns and a Common Consolidated Corporate Tax Base).

### ***II.1 Developments related to the Single Supervisory Mechanism***

The ECB is responsible for the direct supervision of 130 credit institution groups (1,200 individual credit institutions out of the 4,900 individual credit institutions) in the euro area. The 130 groups represent 85% of all bank assets in the euro area. The creation of the ECB's supervisory unit is a huge task, including the drafting of harmonised standards and procedures and the development of an effective and skilled staff (800 supervisors to be selected from a total of 14,000 applicants) and well-functioning infrastructures (IT systems and governance structure).

#### ***II.1.1 SSM progress report (February - May 2014)***

The ECB's second quarterly report to the European Parliament, the EU Council and the European Commission on progress in implementing the Regulation on the Single Supervisory Mechanism provides the following key messages:

- The establishment of the SSM governance structures, including the related organisational rules and arrangements, has largely been completed. The Supervisory Board held five meetings during the period under review and adopted its own Rules of Procedure, which enabled the establishment of the Steering Committee.
- The SSM Framework Regulation was adopted by the Governing Council on a proposal of the Supervisory Board and published on April 25, 2014, together with a Feedback Statement on the outcome of the consultation and the amendments which had been introduced.
- Work on the SSM Supervisory Manual continued, using feedback from the National Competent Authorities (NCAs). The manual is a living document intended for SSM staff that will continue to be updated regularly before and after November 4, 2014 (the operational start of the SSM).



- The establishment of Joint Supervisory Teams (JSTs), the main operational structure for the conduct of supervision by the SSM, has been initiated. All the JST coordinators were appointed by the end of June.
- The staffing of the SSM is proceeding at a satisfactory pace, after initial delays. The large number of applications shows that there is considerable interest in the SSM positions. The timely fulfilment of staffing needs is another main challenge facing the SSM.
- There has been significant progress in the conduct of the comprehensive assessment (see later below).
- The Supervisory Board approved a Supervisory Reporting Manual, which will provide the data framework to support the conduct of supervision.
- The preparatory work is also well advanced in many areas, such as IT infrastructure, HR, premises, internal and external communication, framework for supervisory fees, logistical organisation and legal and statistical services.

### ***II.1.2 Final SSM Framework Regulation***

The SSM Framework Regulation regulates the operation of the Supervisory Board and cooperation between the ECB and national supervisory authorities. Compared to the February draft, the final regulation includes changes and clarifications in the following points:

- Supervision will be conducted on a consolidated basis, by the same JST within a group (even where the group is headquartered outside the banking union).
- The national supervisory authority will be the entry point for both significant and less significant supervised entities.
- An ECB supervisory decision shall be accompanied by a statement of the reasons for that decision and the party affected shall have the right to comment on the decision within two weeks (as opposed to the previously proposed four weeks).
- The previous proposal for the exclusive use of the English language has been relaxed: any one of the official languages of the EU can be used for communication between the ECB and supervised entities.
- A supervised group may be considered significant by the ECB if the ratio of its cross border assets (or cross-border liabilities) to its total assets (or total liabilities) is above 20% (as opposed to the previously proposed 10%).

### ***II.1.3 Comprehensive assessment (AQR<sup>3</sup>) and stress test***

The total amount of risk weighted assets (RWA) of the portfolios selected for the review is EUR 3.72 trillion, equivalent to 58% of total RWA across banks and involving around 135,000 loan contracts. Some 6,000 supervisors and external consultants are involved in the review.

The AQR is conducted in a coordinated manner by the ECB and the European Banking Authority (EBA). The ECB Note on the comprehensive assessment and the common methodology and scenarios for the stress test were published on April 29.

The second (execution) phase of the AQR lasted until the end of July, 2014. It included data validation, sampling, on-site inspection of loan contracts, collateral valuation and the recalculation of provisions and RWA. After completion of the AQR, banks need to hold a minimum of 8% in (Common Equity Tier 1 (CET1) capital.

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<sup>3</sup> Asset Quality Review

For the purpose of the stress test, the minimum CET1 requirement is 8% for the baseline and 5.5% for the adverse scenario. Capital shortfalls will be expected to be covered within six months for those identified in the AQR or the baseline stress test scenario, and within nine months for those identified in the adverse stress test scenario.

Capital shortfalls stemming from the adverse scenario can be covered by using additional Tier1 instruments up to 1% of RWA.

(The use of additional Tier 1 instruments is subject to the following specifications:

Instruments with a trigger below 5.5% CET1: 0% of overall RWA;

Instruments with a trigger at or above 5.5% and below 6% CET1: up to 0.25% overall RWA;

Instruments with a trigger at or above 5.5% and below 7% CET1: up to 0.5% overall RWA;

Instruments with a trigger at or above 7% CET1: up to 1% overall RWA.

The European Systemic Risk Board (ESRB) has provided the following assumptions for the adverse scenarios:

- an increase in global bond yields, especially with regard to emerging market economies
- further deterioration of credit quality in countries with feeble demand
- stalling policy reforms jeopardising confidence in the sustainability of public finances
- the lack of necessary bank balance sheet repair to maintain affordable market funding.

The results of the AQR and stress test will be published in October 2014.

*Terms of reference: Applicable rules on addressing capital shortfalls and burden sharing in the context of the Asset Quality Reviews and stress tests*

Bank may raise capital from the market before the AQR and stress test results are published. (Some banks have already done so).

If the supervisor concludes that material changes in asset valuations are needed, this will have to be promptly communicated to the bank. Banks will be required to disclose the findings and possibly restate the accounts.

If the bank meets any of the early intervention triggers, it will be up to the competent supervisory authorities to require the banks to take the initial steps to address any negative results of the AQR/stress test (which may include early intervention). The authorities have a wide range of powers under the Capital Requirements Regulation and Directive (CRR/CRD IV) as well as under the Bank Recovery and Resolution Directive (BRRD), which must be implemented in national law by December 2014 and will apply from January 2015.

It will be up to the competent authorities or, where applicable, resolution authorities, to determine whether an institution is failing or is likely to fail. Recovery and Resolution Plans will have to be prepared in accordance with the BRRD (initially without and, from January 2016 at the latest, with the bail-in tool).

Should any public capital injection be considered, it would always be subject to the new rules published in 2013, which, as a general rule, require burden sharing from shareholders and junior debt holders, including the No Creditor Worse Off (NCWO) principle.

Public recapitalisations should be the exception rather than the norm and be used only when strictly necessary to remedy a serious disturbance in the economy of a member state and preserve financial stability. The decision in this regard will be taken by the European Commission on a case-by-case basis.

In accordance with the November 2013 ECOFIN statement, all member states will ensure that the necessary tools are in place, enabling them to proceed with required burden sharing under state aid rules and under the BRRD as soon as possible.

### *Disclosure of results of the AQR*

In mid-July, the ECB published the template for the disclosure of results of the AQR. The methodology for the incorporation of the AQR findings into the stress test (join-up) will be published in the first half of August. Banks with capital shortfalls will have two weeks to prepare capital plans.

#### ***II.1.4 Draft regulation on SSM supervisory fees***

This draft regulation sets out how the ECB recovers its expenditures incurred in relation to supervision. Expenditure for banking supervision in 2015 is estimated at around EUR 260 million. For significant supervised entities, the supervisory fees may range from around EUR 150,000 for the smallest ones to about EUR 15 million for the largest ones. Most banks that will be directly supervised by the ECB will pay between EUR 0.7 million and EUR 2 million per year. The largest banks will pay approximately EUR 15 million, the smallest will pay about EUR 2,000. (For indirectly supervised banks, the supervisory fees will range between EUR 2,000 for the smallest ones to EUR 200,000 for the largest ones). The regulation lays down

- the methodology for calculating the total amount of the annual supervisory fees;
- the methodology and criteria for calculating the annual supervisory fee to be levied on each supervised entity and group;
- the procedure for the collection by the ECB of the annual supervisory fee.

(Comments on the draft regulation were invited by July 11. A public hearing was held on June 24.)

In a statement, the European Banking Federation confirmed its commitment to the SSM. The statement emphasises that the supervisory fees should be fair and equitable, the duplication of fees should be avoided and supervisory costs should be transparent.

## ***II.2 Developments related to the Single Resolution Mechanism (SRM) and the Bank Recovery and Resolution Directive (BRRD)***

### ***II.2.1 SRM/BRRD next steps***

Following the adoption by the European Parliament of the SRM/BRRD/DGSD<sup>4</sup> package, the European Commission and the European Banking Authority were required to produce a number of detailed rules in the form of delegated acts and technical standards. Under the BRRD, the European Commission was required to draft, by September 2014, delegated acts on the following:

- The criteria for assessing critical functions and core business lines;
- The exclusion of certain liabilities from bail-in;
- Contract types qualifying for partial transfers;
- Methodology for risk-adjusted fees;
- Registration, accounting and reporting of paid and verified contributions;

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<sup>4</sup> Deposit Guarantee Scheme Directive

- Circumstances and conditions under which the payment of contributions by an institution may be deferred.

The SRM requires the European Commission to adopt delegated acts to determine the rules for the calculation of the interest rate to be applied in the event of a decision on the recovery of misused amounts from the Fund, to determine the types of contributions to the Fund, to determine the timing and the criteria for the spreading out in time of the contributions, to specify the circumstances and conditions under which *ex-post* contributions may be temporarily deferred for individual institutions and to determine the detailed rules for the administration of the Fund and general principles and criteria for its investment strategy.

By December 31, 2018, and every three years thereafter, the Commission shall publish a report on the application of the Regulation, with special emphasis on monitoring the potential impact on the smooth functioning of the internal market.

The EBA has commenced the carrying out of its tasks related to the implementation of the BRRD and the revision of the DGSD. In 2014, the EBA's focus tasks include the drafting of regulatory standards on early intervention, resolution thresholds, recovery plans, valuation and regulatory standards and guides related to the DGSD and to bail-in.

The European Commission has set up a task force to select the chair, deputy chair and four permanent members of the Single Resolution Board (SRB). It will start staff recruiting, to have a staff of 30-40 by the end of Q1 2015. The total staff will be between 250 and 300.

### ***II.2.2 Intergovernmental agreement (IGA) on the Single Resolution Fund (SRF)***

On May 21, 26 member states signed the intergovernmental agreement on the Single Resolution Fund. By signing the IGA, member states have committed to transferring resources from their resolution funds to the SRF and to progressively merge their national resolution funds (compartments) into a Single Resolution Fund. This is an important step towards a Single Resolution Mechanism and key to the implementation of the banking union. The IGA is a building block of the SRM and a prerequisite for the application of certain elements of the SRM. Signatory member states will have until January 1, 2016 to ratify the ISA.

### ***II.2.3 Draft regulations on contributions to resolution financing arrangements and on administrative costs of the Single Resolution Board.***

The European commission is drafting a delegated act on contributions to resolution financing arrangements and an implementation regulation on contributions to the Single Resolution Fund. Both pieces of legislation are planned to be adopted in September.

The regulation on the method and rates of contributions to resolution funds was drafted by a working group, based on the following principles:

- The SRF will be created as a common goal of the participating member states.
- Risk-adjusted contributions should be determined based on several risk factors, and in a way that ensures that the formula remains transparent and the calculation remains simple.
- The risk-adjusted part of the contribution should be commensurate with the probability of failure of the institution (the institution's dependency on the Fund).
- The principle of universality should be applied: all institutions should contribute to the Fund. (The risk adjustment of the contribution may not be of a size that would reduce the contribution to zero and no institution may be exempt from the contribution).

- The flat rate, reflecting the bank's size, should be the prominent part of the contribution.
- Risks should be assessed on an ongoing basis.

The European Commission solicited data from member states by June 1, 2014, to support the development of the specific rules.

The EBF pointed out the following aspects in relation to contributions to the SRF:

- Decisions must be based on correctly compiled and up-to date figures. Any individual bank data and indicators used in contribution calculations should be harmonised and comparable.
- Principle of universality (no exceptions): All institutions should contribute in a proportionate way to their respective resolution financing arrangements.
- The flat part and the risk adjusted part should be well balanced. The decision of the weighting scheme and the calculation method for combining the flat and risk adjusted parts should be postponed until the final risk indicators are known and a proper impact assessment has been conducted.

Based on the meetings of experts from member states, the following agreements are taking shape:

- Application of the principle of proportionality. Small banks – in six size categories – will pay a lump sum contribution. (Small bank are those with a BRRD contribution base (total liabilities less own funds and covered deposits) not greater than EUR 300 and total assets not greater than EUR 1 billion or less). Institutions with BRRD contribution base lower than EUR 50 million shall pay a contribution of EU 2,500, those with a contribution base between EUR 250 million and EUR 300 million will pay a contribution of EUR 60,000. Exceptionally, small banks with especially risky business models may be levied a risk-based contribution).  
The application of the principle of proportionality to other institutions (such as investment firms, money market structures, MREL exempt institutions, EU branches) is being investigated.
- In calculating the contributions, the solo approach should be applied. Intra-group liabilities should not be taken into account in the calculation.
- The contribution base as per the BRRD should be adjusted by a multiplication factor. According to the evolving proposal, the multiplication factor would be between 0.75 and 1.5.
- In determining riskiness, the following weights should be applied: risk exposure: 50%, stability or volatility of funding: 20%, systemic importance of the institution: 10%, other risk factors: 10%.

#### ***II.2.4 ESM direct bank recapitalisation instrument***

In June 14, the 18 eurozone member states reached preliminary agreement on the ESM Direct Recapitalisation Instrument ((DRI). The DRI will take effect after member states have put in place the relevant procedures and the ESM Board of Governors (made up of the eurozone finance ministers) has adopted a unanimous decision on the application of this new instrument. The DRI can be used by systemically important banks or those posing a threat to financial stability, which are unable to attract sufficient capital from the market or be recapitalised by bail-in. A condition for using the DRI is that the bank should come under

direct supervision by the ECB. With the DRI, the ESM Board will temporarily become a shareholder of the bank, with its stake to be sold at a later stage based on a decision of the ESM Board. The ESM has EUR 60 billion for the DRI. (The ESM's lending capacity is EUR 500 billion, of which it has thus far used EUR 41.3 billion for lending to Spain. In the case of Cyprus, the ESM has a lending commitment of EUR 9 billion, of which EUR 4.7 billion has been used).

(As a comparison: the SRF is to be filled up to the target level of EUR 55 billion over eight years).

Member states may only recapitalise banks subject to EU approval, in accordance with the rules for state aid. Member states may borrow from the ESM for bank bailouts.

### ***II.3 ECB reporting – AnaCredit project***

The ECB – also in relation to its supervisory role – is accelerating its work to create a central credit register. It would like to set up an Analytical Credit Dataset by December 2016. This database would be uploaded with data from central credit bureaus operating in some member states and data obtained from direct bank reports. The ECB would also ask for and store a number of data that are not currently available in banks information systems. A precondition for the feasibility of the database is a minimum harmonisation of data collection. This is a top priority of the project.

The EBF summarised its position in a letter, pointing out

- the need for ongoing consultation,
- the priority of a risk-based approach,
- the costs and burdens entailed by the project, the need for a cost/benefit analysis,
- the importance of enabling banks to familiarise themselves with the reporting templates,
- the related data protection and data processing difficulties, and
- the importance of the principle of proportionality.

### ***II.4 Other EU developments***

In May, the European Commission adopted the long awaited Implementation Technical Standards for supervisory reporting. The reporting requirements related to capital, leverage ratio and liquidity ratios will be applied for the first time for reports on the period ending March 31, 2014, to be submitted by the end of June (as opposed to the previously proposed end-April/end-May).

In late June, the Commission also adopted a number of other standards drafted by the European Banking Authority, including, inter alia, those on information to be disclosed by competent authorities (supervisors) and those on the definition of material risk takers for remuneration purposes.

In relation to capital adequacy regulation, the European Systemic Risk Board published an important recommendation on guidance for setting countercyclical buffer rates. In June, the ESRB Advisory Scientific Committee published a report entitled “Is Europe Overbanked?”. Also, the ESRB published an assessment on the macroprudential mandate of national authorities.

## **III. European Banking Authority**

### ***III.1 EBA Work Programme 2014***

In line with its mandate, the EBA's operation in 2014 are focused on three core areas: regulation, oversight and consumer protection. The EBA plays a central role in the development of the Single Rulebook in banking, which is key to achieving a level playing field and a single financial market. The EBA's regulatory work stems from CRR/CRD IV and the BRRD, and in 2014 will focus in particular on credit and market risk, liquidity, the leverage ratios and recovery and resolution. In relation to regulation, the EBA has updated its 2014 Work Programme based on the European Commission's calls for technical advice. In its oversight role, the EBA's activities are focused on identifying, analysing and addressing key risks in the banking sector in the EU. The EBA continues to monitor capital levels, as well as capital plans, with the aim of converging towards the new standards.

In the area of consumer protection, the EBA works towards fulfilling its mandates as laid down under the Mortgage Credit Directive (MCD), the Bank Account Directive and the Payment Services Directive (PSD).

### ***III.2 Report on risks and vulnerabilities of the EU banking sector***

In June, the EBA published its fifth semi-annual report on risks and vulnerabilities of the EU banking sector. According to the report, throughout the first half of 2014, the EU banking sector continued to see improvements in market sentiment, both on the debt and equity side. Banks continued to raise equity ahead of the 2014 EU-wide stress test. The capital raised is allowing banks to continue the repair of their balance sheets and additional provisioning without compromising their capital adequacy. The improvements on the banks' assets side were coupled by a deleveraging process, which has led to the shrinking of balance sheets by EUR 3.4 trillion since 2011. However, the quality of some banks' loan portfolios has continued to decline, pointing to the need for rigorous asset quality reviews. Heavy debt overhang in the public and private sectors and the necessary restructuring of the corporate and households sectors may also pose significant challenges in maintaining adequate capital levels within the EU banking sector. Therefore, the ongoing repair of balance sheets and sector restructuring will remain a key priority in the medium term.

EU banks' income and profitability continued to face significant headwinds and the looming redress costs related to conduct issues are a key concern. Banks with an ROE of less than 4 % represented 39 % of total assets of the sample in December 2013.

According to data as of end-2013<sup>5</sup>, the weighted average tier 1 ratio excluding hybrid instruments was 11.6 % in December 2013. As a result of the cleaning up of balance sheets and taking on legal charges, capital positions decreased: T1 capital declined by 1.1% (EUR 13.9 billion). This decrease in capital positions was outpaced by the EUR 215.4 billion (-2.2%) decline in RWAs. The ratio of non-performing loans (loans past due for more than 90 days) to total loans increased by 0.2 percentage points, to 6.8%. Profits declined by 58% in 2013 over the previous year.

### ***III.3 Consultation on a framework for common supervisory procedures and methodologies***

In early July, the EBA launched a consultation on its draft guidelines for common procedures and methodologies for the supervisory review and evaluation process (SREP). The proposed guidelines will be applied by all supervisory authorities in the EU (including the ECB) and

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<sup>5</sup> Source: EBA Risk Dashboard Q1 2014

represent a major step towards establishing a consistent supervisory culture across the single market. The guidelines address four main components: (i) business model analysis; (ii) assessment of internal governance; (iii) assessment of risks to capital and adequacy of capital; (iv) assessment of risks to liquidity and adequacy of liquidity. The assessment will be summarised in a common scoring and will lead to consistency in setting supervisory requirements to hold additional capital and liquidity resources as needed.

The guidelines recognise the proportionality principle and the importance of supervisory judgement, providing a flexible but constrained framework for all EU supervisors. Comments to the consultation are invited by October 7. The proposed guidelines, as revised based on the results of the public consultation, are expected to be applied from January 1, 2016. However, the guidelines recognise longer transitional arrangements for the application of certain quantitative liquidity and capital supervisory provisions.

#### ***III.4 Regulatory package on the identification of Global Systemically Important Institutions (G-SIIs)***

This regulatory package, published by the EBA in early June, includes draft Regulatory Technical Standards (RTS) on the methodology for the identification of global systemically important institutions, final draft Implementing Technical Standards (ITS) on special disclosure rules applicable to G-SIIs, and final guidelines on special disclosure rules for large institutions. The regulatory package will be part of the EU Single Rulebook and is aligned with the framework established by the Financial Stability Board and developed by the Basel Committee on Banking Supervision.

The EBF found an inconsistency in the ITS on disclosure requirements for G-SIIs. In a letter to the EBA, the EBF requested clarifications as to whether the disclosure requirements will have to be met by July 31 or by 2015 and whether the full data content or only the 12 indicators should be disclosed.

#### ***III.5 The European Supervisory Authorities' Joint Consumer Protection Day***

The European Supervisory Authorities (ESAs) held their second joint Consumer Protection Day on June 4, in London. The event was attended by more than 300 participants, including consumer representatives, academics, legal and financial consultants, national supervisors, and experts from the EU institutions and the financial services industry. A key topic of the event were the proposed harmonised complaint-handling guidelines for the investment, banking and insurance sectors.

#### ***III.6 Other key documents***

- Action plan for colleges of supervisors
- Methodology and macroeconomic scenarios for the 2014 EU-wide stress test
- Draft Regulatory Technical Standards on the treatment of equity exposures under the IRB
- Position on measures to address macroprudential or systemic risk
- Consultation on technical standards on supervisory benchmarking of internal approaches for calculating capital requirements
- List of Common Tier 1 capital instruments
- Final Draft Implementing Standards on leverage ratio disclosure
- Launch of the Interactive Single Rulebook
- Liquidity reporting templates



- Report on the comparability of RWAs for residential mortgages
- Consultation on Regulatory Technical Standards on assessment methodologies for the Advanced Measurement Approaches for operational risk
- Report on the benchmarking of remuneration practices in the EU
- Consultation on guidelines related to disclosure requirements for the EU banking sector
- Revised list of ITS validation rules
- Consultation on Regulatory Technical Standards on the permanent and temporary uses of the IRB approach
- Consultation on draft Regulatory Technical Standards (RTS) on disclosure of information related to the countercyclical capital buffer
- Guidelines on disclosure of encumbered and unencumbered assets
- Guidelines on harmonised definitions and templates for funding plans of credit institutions.

#### **IV. European Banking Federation**

In the second quarter, the European Banking Federation and its Banking Supervision Committee continued to actively work on influencing global and European regulation. Activities were focused on the banking union (the single supervisory and resolution mechanisms), detailed rules of the CRR/CRD IV and the bank structural reform. The EBF provided detailed comments on the SSM framework regulation, the proposal on supervisory fees and the proposal on contributions to resolution funds and communicated its aspects for the comprehensive assessment exercise. It also provided detailed comments on the EBA's draft technical standards and guidelines, in particular in relation to liquidity and leverage. The last remaining step in the European regulatory reform is the structural reform of the banking sector. The EBF gives special emphasis to the strategy to be represented during the legislative process.

The EBF gave its positions on regulatory proposals of the FSB and the BCBS as a member of the IBFed<sup>6</sup> and, in some instances, jointly with other advocacy and industry organisations.

Also in the second quarter, in a press release, the EBF expressed the European banking industry's commitment to financing the economy and fostering growth. It expressed its support of the banking union, while reiterating its opposition to the financial transaction tax and the bank structural reform. In addition, the EBF issued press releases on

- the need for full impact assessment of financial regulation,
- the financing and mutualisation of the Single Resolution Fund,
- the need for the EU to focus on improving the European economy,
- SSM supervisory fees.

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<sup>6</sup> International Banking Federation: 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).