

REPORT

on Activities of the Hungarian Banking Association 3rd Quarter 2014

Budapest, November 2014

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ANNEX 21
INTERNATIONAL DEVELOPMENTS: REGULATION, SUPERVISION 21

I. Executive summary

Although with some fluctuations, the global economic growth outlook is improving, economic activity has increased. The non-euro-zone advanced economies are gaining momentum. The performance of the emerging markets has also improved. At the same time, the recovery of the European economy, fundamentally affecting Hungary's economic performance, is slower than expected. The German economy, appearing robust at the beginning of the year, has lost momentum. As a result, external demand is weaker than expected.

The weakness of external markets is somewhat counterbalanced by the increase in domestic demand. Rising real incomes and favourable labour market developments have contributed to a rising domestic consumption. With the use of EU funding and with the beneficial effects of the MNB's Funding for Growth Scheme starting to be felt, investments are on the rise. Investment in the private sector has also risen. Notwithstanding, the outstanding growth of 3.9% seen in the second quarter year on year halted. Hungary's economic growth is likely to have well exceeded the expected 3% in Q3. GDP growth for the full year is expected to be 3% in 2014. The inflation rate was negative for several months year on year, with a record disinflation measured in September year on year. Then, due to base effects and the increase in services prices, the inflation rate moved backed to the positive range. Core inflation fell to 1.4%. The annual inflation rate is expected at 0.1% in 2014. After reducing the base rate to 2.1% in July, the MNB announced the end of its rate cutting cycle and its intention to keep the base rate steady for a longer time. Money market rates followed the changes in the base rate. Government bond yields continued to fall, improving the financing position of the budget. The labour market is clearly improving, the rate of unemployment was 7.4% at the end of September. The budget deficit is likely to remain under 3% of GDP in 2014. With continued disciplined fiscal policy, the government's deficit target is expected to be met. At the same time, with the existing risks, no significant strengthening of the forint is expected until the end of 2015.

According to MNB statistics, the corporate sector was a net borrower in Q2 2014. With positive trends in Q2, the overall corporate loan portfolio's annual growth rate from transactions rose to above zero percent, that of the SME loan portfolio rose by 1.2%. The total value of new contracts concluded in Stage II of the Funding for Growth Scheme was HUF 325 billion. The credit institution sector's household loan portfolio declined by HUF 61 billion, resulting from disbursements and repayments. The shrinking loan portfolio reflects a continued unwinding of foreign currency loans.

The biggest task for credit institutions in Q3 was the implementation of the "uniformity act" (Act XXXVIII of 2014), providing for the reimbursement of consumers for the exchange rate spread and unilateral interest rate changes, and the Settlement Act (Act XLof 2014) and the related decrees, providing for the rules for these settlements. These acts, adopted with a record speed after the Supreme Court's ruling, largely determine financial institutions' performance in 2014. The sector's ensuing loss is estimated at HUF 900 to 1,000 billion. In addition, the settlements raise a number of accounting and taxation issues.

As law-abiding organisations, financial institutions have duly have met these extremely detrimental regulations, unilaterally burdening them with all the negative consequences of previous lending practices. At the same time, they have tried to present their professional arguments at all forums against these regulations, which they consider unconstitutional.

According to the extremely short deadlines provided by the legislation, banks had until August 25, 2014 to file their lawsuits to disprove the law's presumption of unfairness of their General Terms and

Conditions for FX loans. In these lawsuits, banks proposed that the judges request the establishment of the unconstitutionality of Act XXXVIII of 2014. The Association compiled an analysis with the involvement of constitutional lawyers, providing justifying arguments for the proposal. Some of the first and second instance judges lodged motions with the Constitutional Court. Then the Association sent an amicus curiae letter with a detailed analyses to the Constitutional Court. The letter generated a keen response from the Ministry of Justice and other experts. We prepared a draft submission for a constitutional complaint, which has been used by some of the banks. According to information from members, a number of financial institutions plan to lodge constitutional complaints, however, this depends on the stage of the lawsuits in process.

The banking community tried to prevent the promulgation of the Settlement Act by requesting the President of the Republic not to sign it but to send it for constitutional review, but our request was not favourably considered.

Starting out from the principle of unjust enrichment, specialists from member banks during the summer drafted a transparent methodology, intelligible also for the consumers. However, the legislation provides that the capital prepayment method proposed by the MNB should be applied.

Following this decision, experts from the MNB, banks and the Association worked closely together in developing the detailed rules for settlements and drafting the regulations on the related customer information requirements. During the drafting of the implementation decrees, a number of contradictions and inaccuracies in the Settlement Act were revealed. We submitted to the Ministry of Justice the relevant amendment proposals and issues requiring clarifications.

The issue of the settlement of consumer loan contracts determined the Association's communications in Q3, with four press releases and a note by the Secretary-General published since end-July. In our communications, we first drew attention to the dangers and risks in the process. On adoption of the legislation on July 4, we emphasised that the Act was unfair to the sector, since credit institutions have always provided their services fully in line with the prevailing legislation at all times and their services have been strictly supervised and continuously approved by the legislators and by the supervisory authority. Our professional arguments highlighting the contradictions of the process referred to as the "calling to account of banks" were summarised and published in a note by the Secretary-General on September 18. On September 23, we spoke out against the government's advertising campaign against banks. On the adoption of the act providing for the detailed rules for settlements, on September 29 we published our position and requested the President of the Republic to submit the legislation to the Constitutional Court for preliminary constitutional review.

Another important regulatory development was the Economic Ministry's proposal for amendments to the Credit Institutions Act and the Capital Markets Act. The proposed amendment to the Credit Institutions Act is aimed to transpose the revised EU Deposit Guarantee Scheme Directive and complement and align the provisions of the Bank Resolution Act adopted in early July with the Bank Recovery and Resolution Directive (BRRD). The proposed amendment to the Capital Markets Act, whose purpose, according to its title, is to improve the regulation of capital markets, is primarily aimed to ensure compliance with the EU regulation on central securities depositories and settlements. The package also contains some clarifying provisions.

In global regulation, the Financial Stability Board's activities regarding the regulation of OTC derivatives, the Basel Committee's Basel III monitoring exercise and the BCBS-IOSCO joint survey on securitisation should be highlighted. Both organisations are regularly assessing the progress in post-crisis reforms.

While there was a legislative lull at the European Parliament due to the EU elections, work related to the banking union continued. Preparatory activities related to the entry into force of the Single Supervisory Mechanism on November 4 were completed, the detailed operating rules for the ECB as a supervisory authority and the rules for the payment of supervisory fees and the related sanctions

adopted, and the list of significant credit institutions published. The EBA continues to steam ahead on standards related to the capital and liquidity framework (CRR/CRD IV) and the Bank Recovery and Resolution Directive.

II. Macroeconomic outlook, operating environment

Although with some fluctuations, the global economic growth outlook continued to improve in the past quarter. Apart from short fluctuations, the non-euro-zone advanced economies are gaining momentum. The performance of the emerging markets has also improved, with China seeing a particularly rapid growth. Global economic indicators support analyst opinions that growth will accelerate in the short-term.

The recovery of the European economy, fundamentally affecting Hungary's performance, is slower than expected. The Russia-Ukraine conflict and its economic repercussions are further exacerbating the challenges posed by the weak performance of the external environment relevant to Hungary. These effects are mitigated by the ECB's liquidity programme and the expected weakening of the euro, stimulating exports. Overall, external demand is weaker than expected. While other export markets are ailing, the German economy, appearing robust at the beginning of the year, has lost momentum. This adversely affects Hungarian economic growth and outlook.

The weakness of external markets is somewhat counterbalanced by the increase in domestic demand. Rising real incomes and favourable labour market developments have contributed to a rising domestic consumption. With the use of EU funding and with the beneficial effects of the MNB's Funding for Growth Scheme being felt, investments are on the rise. Investment in the competitive sector has also risen as a result of the increase in domestic demand. As a surprise amidst these positive economic developments, domestic demand, exports and industrial production slowed in August, the latter two due to the summer shutdown of major exporters.

The 3.9% growth seen in the second quarter (putting Hungary second in the EU) has halted. With the weakening of base effects – and despite the extension of the Funding for Growth Scheme and the expected positive adjustment in consumption (mainly in the first half of the next year) as a result of the consumer loan settlements - GDP growth is expected to slow in the coming quarters. Notwithstanding, Hungary's economic growth is likely to have well exceeded the expected 3% in Q3. Although the pace of growth will presumably continue to slow, a GDP growth rate of 3% is expected for 2014.

The inflation rate was negative for several months year on year. Then, due to base effects and the increase in services prices, the inflation rate moved backed to the positive range. A record disinflation was measured year on year in September. Core inflation fell to 1.4%. A number of, in terms of monetary policy external, factors (the government's utility cost cutting measures, the decline of food and energy prices in the world market, unutilised capacities in the economy, a low-inflation environment and moderate wage dynamics) continue to keep the consumer price index low. However, there is no inflation pressure in the economy and this will hold true for the fourth quarter of 2014, so, the inflation rate is expected at 0.1% on an annual basis in 2014. Even in 2015, the inflation rate will only gradually approach the MNB's mid-term target range (3±0,5%).

After reducing the base rate to 2.1%, the MNB announced the end of its rate-cutting cycle in July. Due to inflation fears, there is no need seen for the MNB to start a rate-increasing cycle for the time being, unless to ensure positive real interest rates. This may take place in the second half of 2015 at the earliest, unless a change in the external financing environment forces intervention. Money market rates followed the changes in the base rate. Government bond yields continued to fall, improving the financing positions of the state budget.

The labour market is definitely improving, although the government's active employment policy and the changes in the regulatory environment continue to play a major role. Public works continued to be important, bringing the unemployment rate down to 7.4% by the end of September. The average unemployment rate is expected to be 8% in 2014.

The external financing capacity of the economy will continue to be substantial in the coming years. The budget deficit is likely to remain under 3% of GDP. With continued disciplined fiscal policy, the government's deficit target is expected to be met.

Domestic financing capacity continues to be high, external debt is declining. Gross external debt to GDP may fall from the expected 113% in 2014 to 100% by the end of 2016.

Due to current risks, partly domestic (including the losses imposed on the banking sector in connection with the resolution of the FX loans issue) and partly external (the Russia-Ukraine conflict, expected moves of the FED), the impacts of improving economic fundamentals will not be reflected in the exchange rate of the forint for some time. Also, the big rating agencies are not likely to improve Hungary's ratings until the end of 2015. Accordingly, no significant strengthening of the forint is expected until the end of 2015, however, no necessary weakening from the current level is expected, either.

The financial position of the credit institutions sector in the third quarter was mainly determined by expected losses in the wake of the uniformity and settlement laws related to consumer loans. Although no quantified data are yet available, more provisions and loss accruals are likely to have been made, in addition to the HUF 356 billion of Q1.

Another important development affecting assets in the third quarter was the conversion of two-week bonds into two-week deposits, deteriorating banks' liquidity indicators.

III. Corporate lending

According to MNB statistics, the corporate sector was a net borrower in Q2 2014. With positive trends in Q2, the overall corporate loan portfolio's annual growth rate from transactions rose to above zero percent, that of the SME loan portfolio rose by 1.2%. This means that as a result of transactions, the stock of corporate loans grew by HUF 43 billion. The balance of disbursements and repayments was positive in the case of both forint and foreign currency loans. Gross lending by the overall credit institutions sector amounted to HUF 471 billion in Q2 2014. In the second quarter, banks concluded loan contracts to a total amount of HUF 131 billion under the Funding for Growth Scheme, while disbursements amounted to HUF 117 billion. The ratio of long-term debt in the total portfolio rose slightly.

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 4.53% by August 2014. The interest rates and premiums on small euro-denominated loans increased, the rates on larger loans fell.

As of the end of 2013, the ratio of non-performing corporate loans was 18%, 40 percent of which were commercial real estate loans.

The MNB forecasts a continued increase in loan demand. With the EU grants to be made available in the fourth quarter, businesses' demand for EU grant pre-financing loans is expected to increase, coupled with new investment loans. As a result of the Funding for Growth Scheme, the MNB adjusted its corporate loan forecast upward: SME loans are expected to grow by 3-5% on an annual basis and the overall decline in corporate lending is expected to stop in the next two years.

Funding for Growth Scheme Stage II

With the success of Stage I of the Scheme, on September 11, 2013 the Monetary Council decided to continue the programme. The initial allocation for Stage II was HUF 500 billion. On September 2, 2014, the Monetary Council decided to raise this allocation to HUF 1,000 billion, which may be increased up to HUF 2,000 billion. The council also extended the final drawdown date for financial leasing and EU grant pre-financing to June 30, 2015, while keeping the end-2014 contracting deadline unchanged.

Under the extended Scheme, 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. 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.

Stage II of the Scheme lasts from October 1, 2013 to the December 31, 2014, with two exceptions: new investment loans, investment-related EU grant pre-financing loans and financial leasing facilities and pre-financing loans for annual EU grants can be drawn until June 30, 2015, refinancing loans for factoring can be drawn until December 5, 2017.

90% of the total scheme allocation is for new loans under Pillar I, 10% is for redemption 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.

According to MNB statistics as of August 22, 2014, in Stage I and Stage II more than HUF 1,000 billion worth of contracts were concluded with nearly 13,000 SMEs. The total value of new contracts concluded in Stage II was HUF 325 billion. 98% of the contacts are new loans. In stage II, the share of micro-enterprises in new investment loans rose significantly compared to Stage I, from 33% to 40%. In new loans, 61% were investment loans and leasing facilities, 23% working capital loans and 16% EU grant prefinancing loans. Loan redemptions accounted for a small amount and did not reach HUF 7 billion as of early August. In Pillar I, the average loan amount was HUF 24 million for new investment loans and HUF 57 million for new working capital loans. In investment loans, leasing transactions accounted for over HUF 24 billion, the average loan size was under HUF 10 million. In terms of sectoral breakdown, agriculture, manufacturing and trade continued to have a substantial share in Stage II. Regional concentration decreased with the increase in agriculture's share.

IV. Retail lending

According to the MNB' June 2014 report on Trends in Lending: „In 2014 Q2, the credit institution sector's household loan portfolio declined by HUF 61 billion, resulting from disbursements and repayments. The shrinking loan portfolio reflects a continued unwinding of foreign currency loans, while disbursements exceeded repayments by nearly HUF 40 billion in the case of forint loans. The volume of new loan contracts rose significantly in year-on-year terms, by 45 per cent. The pick-up in lending is most pronounced in the case of housing loans, but personal loans also rose substantially. Banks reported that they had eased credit conditions on housing loans and unsecured consumer credit, primarily in respect of price terms. The total annual percentage rate on concluded transactions declined in the majority of household loan segments, and the spread over the reference rate also decreased in most of them. Responses to the lending survey reveal a pick-up in demand for both housing loans and consumer credit among most banks.”

Developments related to the FX debtor rescue legislation (Act XXXVIII of 2014)

Act XXXVIII of 2014 on the settlement of certain questions related to the Supreme Court's uniformity ruling on financial institutions' consumer loan contracts imposes significant tasks for financial institutions. To prepare for implementation, the Association held several working group meetings and consultations during the summer. We requested rulings from the Budapest Municipal Court regarding the interpretation of the scope of the Act and the calculation of the deadlines provided by the Act. We also held consultations with the Chamber of Auditors and the Chamber of Bailiffs. Involving renowned constitutional lawyers, the Litigations Working Group prepared an analysis on the constitutional aspects of the Act to help banks in the drafting of constitutional complaints.

In the case of foreign currency-denominated loan and financial leasing contracts banks had until August 26, 2014 to file their lawsuits. In their lawsuits, banks normally proposed that the judge request the establishment of the unconstitutionality of the Act. The analyses completed by the Association provide arguments for these requests. The Act has set a separate deadline for HUF-denominated loan contracts. Lawsuits have had to be filed between 90 and 120 days from the date of entry into force of the Act (July 19), that is, between October 18, 2014 and January 15, 2015. Act XL of 2014 has amended the scope of application of Act XXXVIII of 2014, extending it to include real foreign currency loans, while providing that in the case of HUF-denominated loan contracts and real foreign currency loan contracts, unfairness should not be a priori presumed in respect of amendments to banks' General Terms and Conditions published after November 26, 2010. In respect of these amendments, the MNB may file public interest cases between February 14 and February 28, 2015. The deadline for the filing of lawsuits in the case of HUF-denominated loans and real foreign currency loans has been amended to between January 5 and January 12, 2014. The deadlines are preemptory. In the case of foreign currency-denominated loans, most of the litigations were concluded at the appeal courts in November. Apart from one or two rare exceptions (where fairness was established in respect of certain General Terms and Conditions in some short periods), banks have definitively lost the cases. Most banks will request a Supreme Court review, but this has no suspensory effect on the execution of the decision.

Following the first constitutional review motions filed by the judges in ongoing lawsuits, the Association sent an amicus curiae letter with a detailed analysis to the Constitutional Court. The letter generated a keen response from the Ministry of Justice and other experts. We prepared a draft submission for a constitutional complaint, which has been used by some of the banks. According to information from members, a number of financial institutions plan to lodge constitutional complaints, however, this depends on the stage of the lawsuits in process. Following the adoption of final decisions, more constitutional complaints are expected to be lodged, based on the Constitutional Court Act.

Act XL of 2014 (Settlement Act) – Amendment proposals submitted to the Ministry of Justice, letter to the President of the Republic

The Minister of Justice submitted the framework rules for the settlement of retail loans due to the exchange rate spread and unilateral contract amendments on September 12 under Draft Law No. T/1272 (draft law on rules of settlement and other provisions related to Act XXXVIII of 2014 on the settlement of certain questions related to the Supreme Court's uniformity ruling on financial institutions' consumer loan contracts). We provided a number of amendatory proposals to the draft law, but with little results. We proposed that the principles of settlement should be comprehensively regulated by an Act. We also submitted proposals for the method for the recalculation of the exchange rate spread, the counting in of debt forgiveness granted by banks, provisions to amend

banks' General Terms and Conditions in line with the prevailing regulations, and proposals regarding taxation issues. We drew the Justice Ministry's attention to the need to conclude the invalidity lawsuits filed prior to the enactment of the uniformity act and the need to review the Civil Code's regulation of declaratory lawsuits.

Following the adoption of the Act on September 24, we wrote a letter to the President of the Republic, asking him not to sign the Act but to send it for review by the Constitutional Court. In our letter, we pointed out that the Settlement Act contained provisions related to the implementation of a law in connection with which there were now several proceedings before the Constitutional Court. We also pointed out that there were a number of other constitutional queries concerning the Settlement Act (the violation of legal certainty, the prohibition of retrospective legislation, the violation of the principle of equal treatment, the right to fair procedure, the principle of clarity). The President of the Republic signed the Act on October 4, 2014.

The promulgated Act (Act XL of 2014) complements, amends and corrects Act XXXVIII of 2014. It extends the scope of the legislation to contracts performed in foreign currency (FX-FX contracts) and provides that contracts made after November 2010 should not be a priori presumed to be unfair. In these cases, the MNB may file a public interest case for the declaration of unfairness. A problem in this respect is that the legislators have failed to distinguish contracts containing a "list of reasons" as provided by law, so, due to the similar contents of banks' General Terms and Conditions, it might happen that public interest cases are filed in cases where final court decisions have already been adopted. Also, the Settlement Act has extended the scope of application of Act XXVIII of 2014 to include loan contracts terminated through early repayment and contracts terminated through purchase by the National Asset Management Company. In these cases the Act has a priori excluded banks from remedy.

Draft decree related to the Settlement Act

Pursuant to the Settlement Act, the calculation methodology for settlements, the dates (inter alia, the accounting date and the deadline for settlement) and the form and content requirements for the accounts and for consumer information should be regulated by a decree. The Act reaffirmed that, rather than the simpler and more transparent method proposed by the Association, the principal prepayment calculation method should be applied. This concept will cause additional losses to the banking sector and our efforts to change it were without success.

The MNB started the drafting of the relevant decree by holding a briefing for a wide range of banks on September 15. At the briefing, the MNB gave a broad outline of the issues to be addressed in the decree and initiated a consultation with the banking sector. In addition to the principal prepayment method (Method I), the MNB presented and additional two, mathematically equivalent, formulae. To ensure efficiency, consultations on these proposals took place with a smaller group of experts from banks.

During the consultations between the MNB and the Association it soon became obvious that the additional formulae suggested by the MNB (Methods II and III) were not suitable to handle loans with (even temporary) delinquencies, loans subject to the Exchange Rate Cap Scheme and loans where concessions have been granted to the debtor, together representing 80%-90% of the total stock of contracts. Hence, in September, the expert group started to develop the detailed calculation formulae based on Method I.

In relation to customer information, our experts requested that a reasonable settlement process with reasonable deadlines and a solution that does not make banks' operations impossible and does not require excessive human and technical resources be developed. With a view to this latter aspect,

the Association's experts submitted proposals for a two-step customer information process and for related remedies.

The consultations on the decree related to Act XL revealed several issues and inconsistencies in the Act. Accordingly, the Association submitted amendment proposals to the Act in several rounds.

Employer's support for mortgage loan repayments

Many people would like to avail themselves of the employer's support for mortgage loan repayments. However, issues keep arising in relation to the implementation of the relevant regulation. While we sought to solve the issues raised internally within the framework of our working groups, there are a number of issues that require regulatory amendments or authority rulings. We raised these issues in letters to the Ministry for National Economy and the Ministry duly responded to our questions. Most recently, we submitted to the Ministry the following proposals:

- The customer should not be required to obtain authority certificates to certify certain eligibility criteria (e.g., number of people moving together into the flat, number of children pledged): the submission of the loan contract should suffice, since the bank could only disburse the loan if the relevant eligibility criteria have been met,
- The customer should not be required to retrospectively obtain construction and installation invoices where these small-value invoices contain both eligible and non-eligible items. As a customer-friendly solution, the regulator should consider all items in such invoices as eligible for support.

No answer has yet been received to these proposals.

V. Other important regulatory developments affecting banks

Transposition of the revised Deposit Guarantee Scheme Directive, amendments to the Credit Institutions Act

The Deposit Guarantee Scheme Directive (DGSD) adopted in April is aimed at providing uniform protection for all depositors across the EU. The revised directive extends the scope of covered deposits: it allows the deposits of smaller local authorities to be covered. Deposits resulting from certain sources, such as real estate transactions relating to private residential properties, or severance pay, will be protected above EUR 100,000 for a temporary period. The revised DGSD abolishes the special regulation of community deposits, reduces the reimbursement deadline and provides for standardised depositor information.

We commented on both the concept and the text of the Act implementing the DGSD. We pointed out that the recently adopted bank resolution framework should play a major role in the rethinking of the deposit insurance system. The interaction between these two system – deposit insurance and bank resolution – is in that a viable resolution institutional system (legislation, resolution authority, resolution fund) and an efficient supervisory authority can substantially reduce the probability of any compensation from the deposit insurance fund becoming necessary at all. We proposed that the risk pool interlinking banks with credit co-operatives through the OBA should be ended due to the disproportional distribution of the losses and the unilateral disadvantages to banks. (In the past twelve years, the National Deposit Insurance Fund (OBA) had to pay compensation to customers in six instances. All six cases were due to the bankruptcies of co-operative credit institutions, whereas 85% of the OBA's funds come from commercial banks).

Amendment to the Capital Markets Act

This amendment package, whose purpose, according to its title, is to improve the regulation of capital markets, is primarily aimed to ensure compliance with the EU regulation on central securities depositories and settlements. The package also contains some additional clarifying provisions.

Our comments on the package were primarily focused on making the provisions on lien on securities unambiguous and making electronic contracting easier. Also, we submitted proposals for some minor but important changes to make the Stability Savings Accounts and the Preliminary Pension Savings Accounts (NYESZ) more attractive. For creditor protection reasons we expressed our objection to allowing the designation of a death beneficiary for securities accounts and the related customer accounts.

VI. Developments related to supervision

MNB reporting requirements 2015, new extraordinary reporting requirements

The MNB sent banks the **draft decree on reporting requirements for 2015** for review before its submission for public consultation. During the review, we indicated a number of concerns to the MNB. We pointed out that the 2015 reporting requirements do not reflect the objective of data rationalisation as emphasised and promised during the merger of PSZÁF into the MNB. The replacement of data tables and the inclusion of new data tables imposes requirements of a degree of complexity which banks will not be able to prepare for during the autumn. The reporting entities are busy with implementing the Single European Rulebook introduced from 2014 (CRR/CRD IV) and the related reporting requirements, and the MNB's systems are not yet working smoothly, either. The technical, human and financial resources available for reporting are limited due to the FX loan settlement requirements.

Several of our proposals were accepted by the MNB. Accordingly, the provision reducing the reporting deadline was removed from the revised draft submitted for public consultation and the data will continue to be reportable in HUF million. Furthermore, the deadlines for the comprehensive reports on retail and corporate loan contracts were extended by 3 and 6 months respectively.

During the quarter, we also took action for the extension of the deadline for the **extraordinary reports related to the Bank Resolution Act** (originally providing just two weeks for preparations). A major problem was that the MNB solicited data that are not stored in the banks' systems and therefore, cannot be automatically retrieved (for example, the separation of deposits by OBA compensation limits on the liabilities side of the supervisory balance sheet and the breakdown by Bankruptcy Act categories are a problem. Also, the determination of the time to maturity requires a new type of assessment). Several of the definitions in the reporting guide were ambiguous and banks' questions were answered by the MNB only a few days before the reporting deadline. The extension of the reporting deadline would have also been warranted by the fact that the deadline for the transposition and application of the Bank Recovery and Resolution Directive is January 1, 2015. Following several exchanges of letters, the MNB decided not to extend the reporting deadline. However, it indicated that in checking the individual reports, it would consider the circumstances of the reporting entities.

A general experience regarding the imposition of new reporting requirements is that the relevant regulations are drafted quickly without considering their practicability. Banks' need time to prepare their systems and the MNB does not allow for enough time. The MNB's quick reporting requests do not mention whether or not estimates are/might be acceptable. The reporting entities are meeting

their reporting obligations in a responsible manner, although the decrease in resources (whether human, technical or financial) is felt by them as well. The unmanageable deadlines are detrimental to data quality, which is not in the regulator's interest. We would expect a more fair process and more cooperation in the imposition of any new reporting requirement.

Review of the MNB draft decree on the applicable discount rate for variable remuneration

In mid-August, the MNB published for review its draft decree on the applicable discount rate for variable remuneration. In addition to members of the Association's Human Resources Committee, the draft decree was circulated to the secretariats of all member banks for comments. The decree was aimed to transpose into Hungarian legislation the relevant guidance issued by the European Banking Authority (EBA) as mandated by the CRD. In addition to some minor form and content adjustments, we proposed the alignment of the calculation formula to the EBA recommendation. Our proposals were incorporated in the decree, which was issued on October 9.

Financial Navigator Booklets

The MNB Financial Consumer Protection Centre is launching a publication series entitled "*Financial Navigator Booklets*". The publication series includes thematic booklets on 40 topics related to finance, investment and self-provision. The booklets are planned to be issued in 2014 and in the first half of 2015 and would be made available at bank branches, for which the MNB asked the Association's assistance. Endorsed by the Board, the MNB's request was forwarded to all members. We will be given the opportunity to review and comment on the contents of the booklets before publication. The first booklets will be about the risk of indebtedness, the question of what to do in case of payment difficulties, and issues related to complaint handling.

Conference on consumer protection and conciliation

At the conference on consumer protection and conciliation, the MNB said it would support the extension of the definition of consumer to include SMEs, municipalities and condominiums. The Financial Arbitration Board proposes a broader definition, to say 'financial consumer'. The representative from the MNB said that although there is no product licensing, the supervisor should be familiar with the products of the supervised bank, articles published about the bank, blogs entries about the bank, etc.

The MNB Financial Consumer Protection Centre is conducting a "white spot research" to identify those areas where the financial services are least accessible.

VII. Payments

SEPA – Regional meeting, new SCT members

Austria, the Czech Republic, Hungary and Slovakia established a regional SEPA cooperation framework in the early 2010s. The SEPA Working Committee, now operating under the auspices of the Hungarian Banking Association represented the Hungarian banking community for the first time at the regional cooperation meeting of the four countries.

At the meeting, we briefed participants on the Hungarian Banking Association taking over the responsibilities of the dissolving Hungarian SEPA Association. Participants reviewed the status of SEPA migration against the end-date regulation and established that all euro-zone member states have completed migration to SEPA by the set deadline. As for Hungary, the proportion of SEPA

payments (almost exclusively credit transfers) is acceptable in terms of both transactions received and transactions sent (in terms of both transactions numbers and values), especially in light of the fact that the end-date for Hungary is October 31, 2016. The Austrian-based, bank-owned Stuzza Institute held a presentation on the adoption of *QR codes*, which are increasingly widespread also in Austria: QR codes are now shown on all utility bills, thus promoting mobile payments. QR codes are now also shown on pre-completed mailed payment instructions.

In the pan-European context of SEPA, participants addressed the proposed revision of the Payment Services Directive, in particular regarding the definition of payment services and the extension of the scope of payment service providers. Special emphasis was given to services involving Third Party Service Providers (TPPs), in particular in terms of security and liability issues related to their involvement in the initiation of payments and the provision of account information. Participants also reviewed the scope of competence of the Euro Retail Payments Board, created by the ECB to replace the SEPA Council. Participants also addressed the organisational and operational framework of the new EPC. The issue of how the four cooperating countries could represent themselves in the EPC's two new management bodies was raised. Since the seats on these bodies are allocated based on member states' payment volumes and in view of the fact that members may acquire a seat together, it was proposed that the four countries' SEPA organisations should form a coalition. On our part, we said that our SEPA Working Committee would discuss the proposal and revert to the issue at the next regional meeting.

As another important development in the third quarter, with the support of the National Adherence Support Organisation (NASO) operating under the SEPA Working Committee, additional credit institutions (Duna Takarék Bank Zrt. and Polgári Bank Zrt.) joined the SCT Scheme in Q3.

SOFORT – Communication by the MNB and the National Consumer Protection Authority

In the first quarter, some members reported the issue of a third party service provider (TPP) – specifically, SOFORT AG. - being included in the payment chain in online shopping transaction. Services provided by Third Party Service Providers are not considered as payment services under the current payment regulations. At the same time, the statutory requirement to be met in the relationship between the bank and the customer, namely, the non-sharing of the customer's security identifiers with any third party, is compromised, and the liability issues related to risks that may arise during performance are currently not addressed.

After review of the issue by the IT Working Group and the Board, the Association turned to the MNB, requesting a ruling regarding the practice to be followed by banks until the relevant provisions of the PSD take effect.

In response, the MNB issued a communication in cooperation with the National Consumer Protection Authority (NFH), drawing attention to the risks in TPP services, with a view to raising consumer awareness and protecting consumer rights in online payments. The communication establishes that this new service entails significant security risks for the consumer in terms of abuse of customer data, the unauthorised acquisition of which may cause significant loss to the consumer. The sharing by the customer of his online banking security codes with a third party may violate banks' security requirement of not sharing secret information. The communication stresses that Third Party Service Provider's activities are not considered as payment services and therefore are not subject to supervision even in consumer protection terms by the MNB. The National Consumer Protection Authority does have a general power of competence in relation to these services, however, any claims for damages may only be enforced by litigation in court. The communication suggests that before using these services, customers should seek information as to the options available to them to

enforce their consumer rights. The issuers of the communication expect the revision of the Payment Services Directive, that is, the provision of appropriate and clear security requirements and consumer protection rules to eliminate the risks related to TPP services. In the meantime, they emphatically draw attention to the risks involved in online payments.

CLS – Association request to the MNB for the extension of the deadline

At the MNB's request, the Association is involved in the CLS programme, originally planned to be concluded in April 2015. This programme is aimed to connect the forint as a foreign currency to the Continuous Linked Settlement System operated by CLS Bank.

The Association's Board reviewed the issues related to the implementation of the legislation adopted in the wake of the Supreme Court's uniformity ruling on FX loans. The Board established that the exchange rate and interest compensation to be provided to customers and the future conversion of FX loans into HUF would have a fundamental impact on the FX positions and transactions of most member banks during the next six months, significantly overriding their business plans. At the same time, the setting up of CLS projects at the individual banks and the start of the implementation of the CLS programme will also be due in the same period.

To ensure the successful implementation of these two interrelated tasks, the Association's Board initiated with the MNB that the timetable for the CLS programme be aligned with the timetable set for the implementation of the FX loan-related tasks, since it will be only banks can only develop accurate business plans once the FX loans are settled. The Association requested the extension of the deadline for the start of CLS settlements from the second half of 2015 to the beginning of 2016.

Plans to terminate the GIRO IG1 platform

As a major change, GIRO plans to migrate the items from its overnight processing platform IG1 to its daytime processing platform IG2. The shift is being prepared by GIRO's Banking Working Group, however, given the importance of this change, the Association's Payment Working Group has also given its position.

The biggest challenges from a banking point of view are the migration of collections (direct debits, administrative collections) and MNB's and GIRO's plan to complete the migration in the first quarter of 2016. Specialists from member banks object to the contents of the project as well as to the deadline:

- although the process of direct debit would remain unchanged in the bank-to-customer space, the debiting and crediting of the individual items to the accounts directly by GIRO would be a major change in the inter-bank space. At the same time, in the case of queue items, the current - basically credit transfer – system would remain (in other words, banks would have to operate a mixed system),
- banks would have to implement the required development projects basically in 2015, whereas most banks are unable to commit the resources required for the project. Namely, the FX loan settlement process and the related huge tasks, the CLS project and the migration to SEPA by the end-date of 2016 should all be taken into account.

Banks propose to the MNB and GIRO to choose the solution that imposes the least workload on banks and to allow sufficient time for implementation, in other words: the direct debit process should remain unchanged in inter-bank space and the standards should only be changed to the minimum extent.

Consultations on the new banknote series

The MNB announced its plan to introduce a new banknote series, the first piece of which would be the new HUF 10,000 note, to be issued on December 1, 2014. Although the counterfeit banknote rate is low, the MNB says that this quiet period should be used to issue a banknote series with much stronger security features. The issue of the new banknotes will require significant development, organisation, education and communication efforts from all players involved, therefore the MNB held several consultations to prepare and coordinate the related tasks. The Association also organised several consultations on the issue:

- banks discussed with the MNB's competent staff how banks can cooperate to ensure that the new banknotes are available in sufficient quantities from day one and how the parties should cooperate in withdrawing the "old" HUF 10,000 banknotes from circulation as quickly as possible,
- a successful consultation, clarifying a number of technical details was held between specialists from banks and producers of new banknote recognition software for cash processing machines.

Consultation on the central customer statements register related to the monthly two free cash withdrawals option

We held a consultation with high attendance by specialists from member banks on the customer statements register related to the monthly two free cash withdrawals option. At the meeting, representatives from BISZ (the company managing the register) briefed participants on the following:

- the regulatory amendments required for the operation of the system had been adopted,
- the services contracts had been concluded with the individual reporting entities,
- the MNB, as the supervisor of the BISZ's activities, had approved the Business Rules of the system.

Thus, the initial upload and test runs of the system can commence as planned in October, and if successful, the system can go live from December.

Participants were given detailed information in the form of presentations and answers to questions on the tasks for the preparatory period and on the operating procedure of the system.

Following the consultation, a regulatory amendment was drafted with the involvement of specialists from member banks to set out the form and content requirements for a statement to allow for the statement provided by the customer at the new bank to override the old statement provided at the old bank. The draft amendment was submitted to the regulator (the Ministry for National Economy).

Bitcoin

Bitcoin is a new, unconventional instrument that can serve as a payment instrument, investment instrument, cash and account money. Its appearance has been made possible by the spread of information technology and the Internet and the widespread use of devices with Internet access. The number of people with mobile phones is higher than of those with bank accounts and an increasingly high proportion of mobile phones are Internet-enabled. It has long been obvious that the Internet is not just a potential banking communication and distribution channel but also enables access to certain financial and payment services by bypassing banks. Bitcoin makes not only banks but conventional money circumventable, moreover, dispensable: it allows an extremely cheap value transfer, which can eradicate financial exclusion and replace expensive money transfer services used for example by migrant workers or refugees in sending money home.

The supervisory and consumer protection authorities, including the ECB and the MNB have also reacted to the appearance of Bitcoin: in their communications they warn of the risks and dangers inherent in this new instrument, which in many respects behaves like money but lacks the attributes of an official currency. At the same time, IT companies welcome and cherish this new instrument, a creature of the virtual world created by them.

Bank cards: Competition for a Hungarian term for “contactless bank cards”

According to the MNB’s Q2 2014 statistics, there are 2.7 million contactless bank cards in use in Hungary, representing 30% of all bank cards. There are more than 38,000 contactless-enabled POS terminals (42%). A significant part of market players in Hungary - now 13 banks - offer contactless payment solutions. Both card associations have introduced the contactless technology in their day-to-day practice (MasterCard PayPass, Visa Paywave). Hungary has a podium place in contactless technology in Europe. However, there is no Hungarian technical or popular term for this innovative technology. (Contactless bank card: „contactless, no-contact, one-touch” card; contactless payment: „paypassing, passing, tapping”). The Association invited a competition to find simple, intelligible and technically proper terms in two categories: one for the cards and one for the payment method.

VIII. Taxation, accounting

Taxation and accounting issues related to the settlement of FX loans

The implementation of the Settlement Act raised a number of taxation and accounting issues. We indicated all these issues in our amendment proposals to the Act. As a general principle, we pointed out that it is unfair that while the Settlement Act applies to the period 2004-2014, the tax implications can only be settled in respect of the period 2008-2014 and offset only against the company tax. This provision is not competition neutral, it limits the amount of refundable tax, and in the case of loss-making institution, it may protract actual financial settlements even for decades. We proposed to pronounce that the limitation period rules shall not be applied to the use of the ensuing tax overpayments. In respect of local trade tax adjustments, we proposed that the provision requiring the submission of separate tax returns by municipality be waived, as it would entail significant administrative burdens for banks with many branches.

Also, we requested that in view of the capital regulations, in order to ensure compliance with the increased capital requirements, impairment on capital increases by financial institutions in subsidiaries subject to consolidated supervision should be recognised as expense incurred in business. Impairment on intra-group capital increases carried out to enable compliance with the legislation should not entail any additional capital requirement.

The difference from the settlement of FX loans will be a loss. This will entail a provisioning requirement in 2014. Since the settlements will be concluded in 2015, the provisions will be used in 2015. These provisions are different from the general provisions and therefore should not be treated according to the general rules. Although the proposed regulation will not change the combined two-year company tax liability for 2014-2015, due to the increased company tax liability in 2014 it will reduce the regulatory capital to be taken into account for the purpose of financing limit. Therefore, it would be important to pronounce that the provisions can be recognised in the tax base. We also raised that deferred tax accounting as applied in international accounting standards should be allowed. In reports drawn up according to Hungarian accounting standards this would help financial institutions in meeting the capital adequacy requirements, by reducing the amount of any capital replenishment needed.

Comments on the legislation on the advertisement tax

According to its first version, the Act on Advertisement Tax (Act XXII of 2014) was targeted at companies whose revenues are from advertising services. However, the amendment adopted by Parliament in the summer (concerning advertising for one's own benefit) has significantly extended the scope of taxpayers. The tasks ensuing from the extension of the tax to advertising for one's own benefit imposes substantial administrative burdens even on those businesses which have no tax liability. Namely, upon a tax authority audit, the business must prove that the tax base was below the taxable limit. Therefore, we proposed to abolish the tax on advertising for one's own benefit. In this case, the administrative burdens could be significantly reduced, while the revenue loss for the state would be minimum. This proposal is also in line with Act CXCV of 2011 on the economic stability of Hungary: „33. § In imposing any new payment obligation, it should be borne in mind that the administrative costs related to its imposition, collection, registration and auditing should not be disproportionately high compared to the revenues from it and should not exceed the revenues from it.”

Apart from the reduction of administrative burdens, the proper interpretation of the legislation is also in the interest of all those involved. Therefore, we submitted to the Ministry for National Economy a number of questions that needed clarification in the legislation.

IFRS transition

In the context of IFRS transition, we received for review the draft of the relevant Government Decree. The draft was in accordance with the agreements made at the consultations, with one exception, namely, smaller credit institutions would be able to ask for a postponement or even for exemption from the IFRS. In this context - with a view to the expectation of uniform supervision - we proposed that to use the time available until 2017 efficiently, we should, also centrally, focus on smaller institutions. Experience shows that there is a need for training programmes managed and controlled at the regulatory level. Although there are many training courses in the market, it is difficult for accountants who have thus far only used Hungarian accounting rules to choose between these courses. Also, since the courses largely vary in quality and costs, it would be useful to make available some coordinated assistance, potentially including financial assistance, to help catching up. We also proposed that to ensure successful preparations by the individual entities and for better common results – to neutralise the tax effects of the transition - the Ministry for National Economy should set up a working group to address taxation issues related to the transition.

IX. Association developments

Consultation with the Agricultural and Rural Development Office (MVH)

Promoting lending to large companies and SMEs in the agricultural sector is a priority for the Hungarian Banking Association. To achieve this, the Association initiated a meeting with the Agricultural and Rural Development Office, whose staff were readily available to us. At the meeting, the issues raised by the Association were discussed and clarified. Of particular importance was the acceptance of earmarked accounts (making agricultural financing easier) in the MVH's customer register. At our request, the MVH promptly informed its branch offices accordingly.

New Association publication

The Association is launching a bilingual scientific publication covering a broad spectrum of the economy, with the title *Gazdaság és Pénzügy/Economy and Finance*. We have won over the

Budapest Stock Exchange, KELER, the Confederation of Hungarian Employers and Industrialists (MGYOSZ) and the National Association of Entrepreneurs and Employers (VOSZ) as sponsors for the publication. The publication has been registered by the media authority and, under the chief editorship of Erika Marsi, its first edition will be published in December in print and online on our website and on the co-publishers' websites.

Electronic Channels Working Group established, kick-off workshop

Electronic payment solutions, such as online banking, contactless payments and mobile payments are an increasingly popular product range in the international, European and Hungarian markets. Netbanking is practically available at all banks. The testing of a Mobile Wallet system (MobilTárca) in Hungary was completed in June, and several members have launched their own mobile payment solutions (OPTPay, Erste). Mobile wallets and QR code reading make online payments simpler, safer, and thus, more attractive for customers. The Association organised a kick-off workshop on the issue for interested members in July, in cooperation with MobilTárca Egyesület (Mobile Wallet Association). The workshop was aimed to provide a professional overview, review current market developments and give an update on the results and conclusions of the ongoing mobile payments pilot. The workshop also hosted the first meeting of the new Electronic Channels Working Group, established in response to interest from members. The Working Group's objective is to monitor international trends, evaluate the various technologies and processes, keep track of developments in the Hungarian market and promote the development of the market.

Communications

Media statistics, main topics

The settlement of FX loans was the main topic in our communications in the third quarter, with four press releases and a note by the Secretary-General published since end-July. In our communications, we first drew attention to the risks and dangers in the process. On adoption of the legislation on July 4, we emphasised that the Act was unfair to the sector, since credit institutions have always provided their services fully in line with the prevailing legislation at all times and their services have been strictly supervised and continuously approved by the legislators and by the supervisory authority. Our professional arguments highlighting the contradictions of the process referred to as the "calling to account of banks" were summarised and published in a note by the Secretary-General on September 18. On September 23, we spoke out against the government's advertising campaign against banks. On the adoption of the act providing for the detailed rules for settlements, on September 29 we published our position and requested the President of the Republic to submit the legislation to the Constitutional Court for preliminary constitutional review. We communicated banks' coordinated views, comments and position to the Hungarian and international media and the public mainly through press releases, interviews and statements.

In Q3 we had appearances in the online media in 610 instances, followed by the print media, in 300 instances and the electronic media, in 190 instances. In total, we had more than 1,100 appearances and mentions in the Hungarian media in Q3.

At the Association's press club held on September 19 we announced the competition for a Hungarian term for "contactless cards". We gave journalists a professional overview of this increasingly popular, innovative payment technology. The meeting was attended by the two leading card associations. Both the media and the public have taken a positive interest in the competition.

European Money Week

The European Money Week is a programme launched by the European Banking Federation to promote financial literacy at national and European level. The objective is to raise awareness of the importance of financial education. The programme draws on the experience and success of initiatives implemented in some member states. Participants in the programme will concentrate some actions on financial education during that week, with a view to boosting public awareness and interest. The European Money Week will be held annually, in the second week of March. The first EMW will be held between March 9 and 15, 2015. The Association organised a consultation and workshop on the EMW, attended by banks active and experienced in financial education and institutional experts. The Association's Board supported the Association's participation in the programme. Éva Hegedűs, member of the Board, has undertaken the management of the programme. The development, finalisation and coordination of the Hungarian Money Week programme will be the responsibility of the task force team set up for the purpose.

New head of the Anti-Money Laundering and Terrorist Financing Working Group

The Working Group elected Ildikó Józsa, MKB Bank's Compliance and AML Director as head of the working group for a term of three years. Ildikó Józsa replaces Zsombor Brommer in the post, who continues his career abroad. The main task of the Working Group is to coordinate preparations for the implementation of the Fourth Anti-Money Laundering Directive and for the next Moneyval assessment. Compliance with the sanctions requirements is also a continuing challenge for banks.

INTERNATIONAL DEVELOPMENTS: REGULATION, SUPERVISION

I Global regulation

1.1 Financial Stability Board¹

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

The meeting established that the financial system continues to strengthen, with overall improvements in bank capital and liquidity, however, exceptionally accommodative monetary policies and the search for yield are a risk. Volatility in asset prices has become compressed and asset valuations stretched across a growing number of markets, increasing the risk of a sharp reversal. While leverage has decreased in the banking system, leverage has picked up in other parts of the financial system, including in corporate debt markets. The mispricing of liquidity is also a concern: pressures on market liquidity could exacerbate downward price dynamics and market dislocations during a price fall. Authorities are stepping up the monitoring of the migration of risks to less regulated parts of the financial system. A number of emerging market countries have taken policy measures to reduce risks that could arise from volatile capital flows and market dislocations.

Priorities in the FSB's work plan include the finalisation of certain elements of ending too-big-to-fail, the completion of the regulatory framework for shadow banking, and the making of derivative markets safer. In the wake of the public consultation conducted in August, the FSB will finalise the recommendations on foreign exchange benchmark practices. The FSB continues to work on new standards for accounting, auditing and disclosure. It was agreed that from 2015, the FSB will prepare a consolidated annual report to the G20 on the implementation of the reforms and their effects.

In September, the FSB published a report on jurisdictions' ability to defer to each other's OTC derivatives market regulatory regimes. The report reviewed the regulatory requirements applicable to trade repositories (TRs), central counterparties (CCPs) and exchanges/electronic trading platforms (together, "infrastructure providers") and to market participants.

In another report, the OTC Derivatives Regulators Group addressed issues related to cross-border application. A recommendation will be submitted to the November G20 meeting.

1.2 Basel Committee on Banking Supervision (BCBS)

1.2.1 Meeting of central bank governors and heads of supervision on post-crisis reforms

At the end of September, central bank governors and heads of supervision from 100 jurisdictions met in Tianjin, China, to review progress in post-crisis reforms. Participants also discussed the role of

¹ Financial Stability Board: the highest international body for financial standards

banking systems in promoting growth, making financial services safe and supporting the real economy.

At the meeting, the Basel Committee's membership was expanded to include the European Central Bank's Single Supervisory Mechanism and Indonesia's Financial Services Authority. Representatives from Chile, Malaysia and the United Arab Emirates also joined the Committee as observers.

The Basel Committee also reviewed an updated list of global systemically important banks (G-SIBs) based on end-2013 data. The updated list will be published in the coming weeks. A bank designated as a G-SIB will be required to hold additional Common Equity Tier 1 (CET1) capital of between 1% and 2.5% from 2016. The Committee endorsed the final details of Basel III's net stable funding ratio (NSFR) to take effect in 2018 and the Basel framework's securitisation standard and revised its corporate governance guidance. The Committee addressed banks' risk weighting practices and their convergence, the standardised approaches, modelling parameters and assumptions, and improved disclosure. The Committee will present a report on these issues at the November G20 Summit.

1.2.2 Results of the Basel III monitoring exercise

In September, the Basel Committee published its sixth semi-annual Basel III monitoring report. The report reviews the implications of the Basel III standards for banks based on end-2013 data. A total of 227 banks participated in study, including 102 large internationally active banks ("Group 1 banks", defined as internationally active banks that have Tier 1 capital of more than €3 billion) and 125 Group 2 banks (i.e., representative of all other banks). The results of the monitoring exercise assume that the final Basel III package is fully in force, based on data as of December 31, 2013. That is, they do not take account of the transitional arrangements set out in the Basel III framework, such as the gradual phase-in of deductions from regulatory capital. Data as of December 31, 2013 show that capital shortfalls have been further reduced relative to the target levels. For example, at the Common Equity Tier 1 (CET1) target level of 7.0% (plus the surcharges on G-SIBs as applicable), the aggregate shortfall for Group 1 banks is EUR 15.1 billion, compared to EUR 57.5 billion on June 30, 2013. As a point of reference, the sum of after-tax profits prior to distributions across the same sample of Group 1 banks for the year ending December 31, 2013 was EUR 419 billion. Under the same assumptions, the capital shortfall for Group 2 banks included in the sample is estimated at EUR 2 billion for the CET1 minimum of 4.5% and EUR 9.4 billion for a CET1 target level of 7.0%. This represents a decrease compared to the previous period of EUR 10.4 billion and EUR 18.3 billion, respectively. The Basel III Liquidity Coverage Ratio (LCR) comes into effect on January 1, 2015. The weighted average LCR for the Group 1 bank sample was 119% on December 31, 2013, up from 114% six months earlier. For Group 2 banks, the average LCR remained unchanged, at 132%. For banks in the sample, 76% reported an LCR that met or exceeded 100%, while 8% reported an LCR below a 60% minimum requirement applicable in 2015. The average NSFR for the Group 1 bank sample was 111%, while for Group 2 banks the average NSFR was 112%. As of December 2013, 78% of the banks in the NSFR sample reported a ratio that met or exceeded 100%, while 88% of the banks reported an NSFR at or above 90%.

In parallel with the Basel III monitoring exercise, the Basel Committee also assessed the impacts of the October 2013 fundamental review of the trading book. The quantitative impact study, involving 41 banks from 13 countries, focused on the revised internal models-based approach based on hypothetical portfolios.

1.2.3 Progress report on adoption of the Basel regulatory framework

In early October, the Basel Committee published its seventh report on progress in implementing Basel II, Basel 2.5 and Basel III in the Committee's member jurisdictions. The report is based on information provided by individual members as part of the Committee's Regulatory Consistency Assessment Programme (RCAP). The report reviews the status of adoption of the risk-based capital standards, the standards for global and domestic systemically important banks (SIBs), the Basel III leverage ratio and the liquidity coverage ratio (LCR). The report reveals that the capital standards have been adopted in the vast majority of member jurisdictions, while the other requirements will be implemented over the next few years.

In the context of Basel implementation, on September 3, the US regulatory agencies announced the final LCR rules. Banks with more than USD 250 billion in total assets will have to meet an 80% LCR by January 1, 2015 and 100% by January 1, 2017. Banks with total assets between USD 50 billion and 250 billion are given an additional one year for implementation. The final rule has extended the scope of eligible HQLA² instruments and amended the timetable for the implementation of daily calculations. The LCR will not apply to non-bank financial institutions, these will be subject to prudential liquidity standards based on their specifics. The authorities also agreed on a supplementary leverage ratio, with an effective date of January 1, 2018.

1.2.4 BCBS - IOSCO³ joint survey on securitisation

The Basel Committee on Banking Supervision (BCBS) and the International Organization of Securities Commissions (IOSCO) co-lead a task force charged with undertaking a wide-ranging survey of securitisation markets worldwide. The July exercise was aimed to

- survey securitisation markets with the aim of understanding how they are evolving in different parts of the world;
- identify factors that may be hindering the development of sustainable securitisation markets;
- assess whether there are factors inhibiting the participation of investors, particularly non-bank investors; and
- develop criteria to identify and assist in the development of simple and transparent securitisation structures

Participants were invited to complete the online survey by July 25.

In Q3, the BCBS-IOSCO Joint Forum also published a report on supervisory colleges for financial conglomerates.

1.3 FinCoNet⁴ report on responsible lending

FinCoNet, the International Financial Consumer Protection Organisation, an organisation recognised by the FSB and the G20, in July issued a report on responsible lending practices in the various jurisdictions. The report establishes that regulatory frameworks to support consumer credit and promote responsible lending are in a transition phase, moving towards a more robust and consumer-focused regulatory environment. The current emerging practices reflect a heightened concern about the impact of irresponsible lending on consumers and, as a corollary, on the economy as a whole. These changes are a reflection of the international standards intended to respond to the financial crisis, however, there are also a number of developments outside international standards that seek to advance the interests of consumers. The report addresses, in separate sections, the regulatory regimes for consumer credit, regulatory tools and mechanisms to assist consumers in making a

² High Quality Liquid Assets

³ International Organization of Securities Commissions

⁴ International Financial Consumer Protection Organisation

decision to obtain credit, industry obligations to lend responsibly, regulatory controls and prohibitions on the provision of consumer credit, and supervisory and enforcement tools to ensure compliance with responsible lending obligations. The report identified good practices in the various jurisdictions in case studies and examples.

II European regulation

II.1 The Bruegel Institute on challenges for the EU

Following the EU elections, the Bruegel Institute a European think tank specializing in economics outlined the main challenges for the newly elected EU institutions. According to the Bruegel Institute, the European Commission, the European Council and the European Parliaments face three challenges in the new parliamentary cycle: the economic situation resulting from globalisation and from the crisis (low economic growth, high unemployment, high debt levels), reforming the functioning of the EU institutions while dealing with pressing external matters, and the need for EU treaty change. The latter includes the rethinking of the division of responsibility between the EU and its member states, the identification of those areas where “more Europe” is needed and of those where “less Europe” is needed. The crisis has shown that euro-area countries need deeper banking, economic, fiscal and therefore political integration than envisaged by the Maastricht treaty. Such deeper integration among euro-area countries inevitably raises urgent questions about the relationship between the EU and the euro area.

According to the Bruegel Institute, the EU should appoint a high-level committee to make proposals for a new architecture for the EU and for the euro area. The High-Level Committee should conclude its work and report back to the European Council in December 2016. The High-Level Committee would address three sets of questions.

- 1) Does a monetary union require a fiscal and economic union and what exactly would this imply? In this context, the following themes would need to be explored:
 - What kind of fiscal backstop does a genuine banking union require?
 - Does monetary union require a fiscal stabilisation mechanism?
 - Are the current fiscal rules adequate?
 - Is a mechanism for sovereign debt restructuring necessary? How can the no-bail-out clause be made credible?
 - Should the European Stability Mechanism (ESM) and the European Resolution Mechanism (ERM) become EU mechanisms and be part of a euro-area budget managed by a euro-area treasury? Is the EU budget reform a condition for the creation of a euro-area fiscal capacity?
 - Does the euro area require a ‘finance minister’ with veto power over national budgets and national structural and labour market policies? Should some of these policies become EU policies?
 - What mechanisms of political accountability should be put in place to oversee the euro-area treasury and finance minister and give them political legitimacy?
- 2) What should the relationship be between euro-area and non-euro area EU countries? What safeguards should non-euro area countries receive and how closely should they be linked to the main EU decision-making processes? Should their involvement in the EU be more narrowly based on the single market only?
- 3) Is the current assignment of EU competences adequate? Is the current method for assignment of competences adequate? The treaty specifies that limits to EU competences are governed by the principle of conferral. The use of EU competences is governed by the principles of subsidiarity

and proportionality, the application of which is specified in a protocol. Has the time come to revisit this protocol?

According to the Bruegel Institute, the EU leading bodies should initiate a new treaty before the end of their mandate.

In another report, the Bruegel Institute outlined challenges for the new EU Commissioner for Financial Services. According to the report, the five major challenges for the Commissioner for Financial Services are as follows:

- Implementation of the ongoing legislative agenda (crisis management and resolution, banking union build-up and regulatory streamlining),
- Protection of the integrity of the single market (risk of intra-EU split, the relationship between the UK and the EU),
- Promoting the development of non-bank finance and capital markets,
- Promoting cooperation between the EU financial regulatory institutions (EBA, ESMA⁵, EIOPA⁶, ESRB⁷, SRB⁸),
- Ensuring an appropriate EU representation in global financial regulation.

II.2 Banking union developments: Single Supervisory Mechanism

Preparations for direct supervision by the ECB of the euro-zone's large banks and banking groups were nearing completion in the past quarter. In line with the relevant regulations, the ECB reports progress on a quarterly basis to the European Commission, the European Council and the European Parliament.

Quarterly report on progress in the implementation of the Single Supervisory Mechanism

The third SSM progress report covers the three months between May 4 and August 3. The key messages of the report are as follows: the SSM is now fully operational, the Supervisory Board and the Steering Committee held several meetings in the period under review. The SSM Regulation requires the ECB to establish an Administrative Board of Review for the purposes of carrying out an internal administrative review of the decisions taken by the ECB in the exercise of the powers conferred on it by the SSM Regulation. The Administrative Board of Review is to be composed of five individuals of high repute acting as members, and two alternates. The members of Administrative Board of Review were appointed by the Steering Committee in August. To ensure the separation between monetary policy and supervisory tasks, the ECB will set up a Mediation Panel. The Vice Chair of the Supervisory Board will act as Chair of the Mediation Panel. The Chair of the Mediation Panel will assist member states in the appointment of their members. (The ECB published the decision on the separation of monetary policy and supervisory tasks on September 17). The JST coordinators for the 117 JSTs⁹ have been selected. A large number of JST kick-off meetings have taken place. (The main objectives of the JST kick-off meetings are to enable the ECB and JST members to get to know each other and to agree on a working plan and the modalities for information exchange). Since June, the ECB has participated in meetings of supervisory colleges as observer.

List of significant (and less significant) credit institutions

⁵ European Securities and Markets Authority

⁶ European Insurance and Occupational Pensions Authority

⁷ European Systemic Risk Board

⁸ Single Resolution Board

⁹ The number of 117 JSTs does not correspond exactly to the around 120 significant institutions because some significant institutions are part of the same group

The ECB and the competent supervisory authorities have agreed on the list of significant credit institutions to be directly supervised by the ECB from November 4. The initial list was published on June 26, followed by a final list on September 4, 2014. (The institutions involved had been notified by the same date). The decision has been made based on banks' year-end 2013 figures.

A total of 120 institutions/groups have been classified as significant (97 institutions have been classified as significant based on their size [total assets exceeding EUR 30 billion], 13 based on their economic significance [total assets exceeding EUR 5 billion and 20% of the home country's GDP], 3 based on their cross-border activity and 7 by virtue of being one of the three largest credit institutions in a member state).

The significance of banks will be assessed on an annual basis. In the case of mergers, ad hoc assessments will take place. An institution will immediately be classified as significant if its year-end figures reach the significance criteria. A change of status from significant to less significant requires that significance criteria have not been met for three consecutive years. The ECB may at any time decide to directly supervise any euro-zone bank to ensure consistent application of high supervisory standards.

The scope of significant institutions is somewhat different from those involved in the AQR¹⁰: 116 of the 120 institutions are involved in the AQR. Of the four not involved, three have been classified as significant based on their cross-border activity (this criterion is not taken into account in the AQR).

Among the 128 institutions involved in the AQR, there are 11 not classified as significant. Three of these have not met the quantitative criteria, but in two cases, the maintenance of integrated supervision was an objective.

To enable the ECB to take over the supervision of significant credit institutions, a supervisory fee system has been developed and the ECB has been given powers to impose sanctions on institutions failing to comply with its regulations and decisions.

Guide to banking supervision

At the end of September, the ECB published a document entitled "Guide to Banking Supervision", describing the operation of the SSM. This document presents the principles of the SSM and its operation, including the distribution of tasks between the ECB and the NCAs, the decision-making progress within the SSM, the operating structure of the SSM and the supervisory cycle (the interaction between supervisory methodologies and practices). It also addresses issues related to the conduct of supervision, including authorisations and the withdrawal of authorisations, the supervision of significant and less significant institutions and overall quality and planning control. The guide sets out nine supervisory principles as follows:

1. Use of best practice,
2. Integrity and decentralisation,
3. Homogeneity within the SSM,
4. Consistency with the single market,
5. Independence and accountability,
6. Risk-based approach,
7. Proportionality,
8. Adequate levels of supervisory activity for all credit institutions,
9. Efficient and timely corrective measures.

ECB comprehensive assessment and stress test

The results of the comprehensive assessment of large euro-zone banks were followed with interest worldwide, with the expectation for "healthy" banks to more actively participate in lending to the

¹⁰ Asset Quality Review

economy. The ECB sought to ensure the credibility of the process by ensuring maximum transparency. For example, it published the disclosure process as early as July 17, including the templates to be used for the presentation of the results.

The results of the comprehensive assessment were published on October 26. According to these, capital shortfalls were only found at 13 banks during the AQR (including four Italian and two Greek-based banks), with no institution to be closed down. The assessment found a total capital shortfall of EUR 25 billion (around the minimum expected). The review found that banks' non-performing exposures increased by EUR 136 billion. In addition, EUR 48 billion worth of other assets were found overvalued.

The ECB only disclosed the AQR results after completion of the join-up stress test, together with the results of the latter. (Banks were required to maintain a minimum CET1 ratio of 8% under the baseline scenario after completion of the AQR, and a minimum CET1 ratio of 5.5% under the adverse scenario).

The stress test was conducted for 123 European banks and covered a horizon of three years. The results show that under the baseline scenario of the stress test, EU banks' CET1 ratio would drop by 260 basis points, from 11.1% after the AQR to 8.5% after the stress. The test showed that 24 banks would fall below the 5.5% CET1 threshold over the three-year horizon of the test and the overall capital shortfall would total EU 24.6 billion.

According to the first responses, it is yet unclear to what extent markets accept the better-than-expected results of the test as credible. The comprehensive review can only have a positive impact if it is not too easy and the banks passing the test do not go bankrupt within a short period of time.

According to comments, the AQR and the stress test were also a test of the ECB's ability to carry out its huge task of supervising significant banks.

II.3 Banking union developments: Single Resolution Mechanism (SRM)

The EU regulation on the Single resolution mechanism was published in the EU official journal on July 30, 2014. The regulation, to be applied together with the Bank Recovery and Resolution Directive (BRRD), took effect on August 19. The provisions on the Single Resolution Board and cooperation between resolution authorities should be applied from January 2015. The SRM will be fully operational from January 2016.

The BRRD and the SRM are accompanied by 26 regulatory technical standards and 11 delegated acts, These are being drafted by the EBA.

On October 21 the Commission adopted the delegated act providing detailed rules for banks' contributions to the national resolution funds and to the Single Resolution Fund. The contributions will be made up of two elements:

- a fixed amount determined based on the institution's liabilities (excluding own funds and guaranteed deposits),
- a risk adjusted contribution depending on the risk profile of the institution. The proposal includes a number of risk indicators against which the risk level of each institution will be assessed.

Concurrently with the delegated act, the Commission drafted a proposal for a Council implementing act to specify the methodology for the calculation of contributions.

II.4 Liquidity Coverage Ratio (LCR)

The delegated regulation on LCR was published by the Commission as late as October 2014, hence, it will only take effect in October 2015, nine months behind the deadline set by the Basel Committee. The contents of the delegated regulation were significantly improved during the summer:

- a wider scope of covered bonds and asset-based securities will be eligible as high quality and extremely high quality liquid assets,
- issuers of covered bonds will not be required to have high securitisation qualifications to be considered liquid for LCR purposes. Instead, the regulation will stipulate the minimum information to be provided to purchasing banks.

The Commission's delegated regulation on the identification of the geographical location of credit exposures was promulgated in August.

II.5 Financial Services Committee roadmap on securitisation

In the context of financing the economy, the EU Financial Services Committee (FSC) drafted a roadmap for legislative work related to securitisation, specifying the key areas where the coordination of measures is particularly important. According to the roadmap, the criteria for the identification of sound/qualifying assets should first be defined. These identification criteria should then be consistently applied in the various areas of regulation (e.g., capital, liquidity). The concept of high-quality securitised instruments should already be applied in the current draft regulations (Solvency II, delegated regulation on LCR). Attempts should be made for the EU identification mechanism to be applied in the drafting of global regulation. Should this fail, then the EU treatment should be aligned with the final global standards. The FSC points out the importance of harmonisation of the disclosure rules and retention requirements and the further development of securitised SME financing instruments.

Commission report on the operation of the European Supervisory Authorities (ESAs) and the European System of Financial Supervision (ESFS)

On August 8, the European Commission published a report reviewing the operation of the European Supervisory Authorities (ESAs) and the European System of Financial Supervision (ESFS). The report specifies those areas where further improvements are required in the short- and medium term. According to the Commission, the focus on supervisory convergence should be increased already in the short-term to ensure the consistent implementation and application of EU law, including more and better use of peer reviews and more systematic follow-up. The Commission sees a need to enhance the transparency of the process for preparing draft technical standards and advising the Commission and to ensure, where needed, high quality cost-benefit analysis. The Commission also points out the need to give consumer/investor protection tasks a higher priority by making full use of available powers. The ESAs' internal governance and operation should be enhanced. In the short-term the Commission will take the following actions:

- Make sure that empowerments for technical standards in future legislative proposals have deadlines relative to the entry into force of the basic legal act.
- Pay particular attention to the appropriateness of timelines and to the scope of empowerments for technical standards in draft legislative proposals and during discussions taking place within the legislative process.

In the medium-term, the Commission will examine the need to enhance the powers of the Board of Supervisors. According to the Commission, improvements could be made to the funding arrangements of the ESAs, including the use of alternative sources of funding, ideally abolishing EU and national contributions. The ESAs could have direct access to data where necessary for the performance of their tasks. In the light of the subsidiarity principle, the SEAs' mandates could be

extended to include IFRS enforcement, a stronger oversight role on internal model validation, shadow banking, and the direct supervision of highly integrated market infrastructures, such as CCPs. The ESAs mandate in the area of consumer/investor protection could also be enhanced.