



HUNGARIAN BANKING ASSOCIATION

REPORT

**on Activities of the Hungarian Banking Association
1st Quarter 2011**

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I. LEGISLATION, SELF REGULATION

1. Eviction moratorium

Draft Law No. T/2605 on amendments to the Act on Judiciary Distraint was adopted by Parliament under urgency on March 16, 2011. The draft law had been submitted to Parliament as an independent MP motion without consultation with government bodies or professional organisations.

The draft law sought to postpone the lifting of the eviction moratorium for an indefinite period, with a provision that the suspension of the moratorium would be provided for by separate legislation.

The amendment upholds the moratorium in a narrower scope: evictions continue to be prohibited after April 15 in respect of real estates provided as collateral for home loans and in respect of mortgage loans granted for any purpose if the loan has been used for home purchase. Eviction is also prohibited if any other debt collection procedure is in process against the debtor, in addition to his/her mortgage loan debt.

We considered that extension of the moratorium for an indefinite period was highly risky, in terms of mortgage lending activity, moral hazard and investor confidence. Hence, in a letter to the government and leading officials of the ruling coalition's parliamentary group, we requested that, in view of the advanced stage of negotiations between the government and the Association, the government reconsider its position and take the relevant MP motion off the agenda.

Although the draft law was upheld, under an MP motion submitted on March 16 an end date was set for the moratorium: evictions can be postponed until July 1, 2011. Also, to increase debtors' willingness to pay, the scope of those eligible for postponement due to another debt collection procedure in process against them was narrowed by providing that such debt may not exceed HUF 150,000. Act XVIII of 2011 amending the Act on Judicial Distraint entered into force on March 23, 2011.

2. Hungarian Financial Supervisory Authority Consumer Protection Recommendation

The Hungarian Financial Supervisory Authority sent us for review its proposed Consumer Protection Recommendation, formulating authority expectations over and above the requirements provided for by law.

In our position, developed based on comments received from banks, we welcomed the opportunity to familiarise ourselves with the Authority's principles regarding consumer protection. At the same time, we assessed the expectations provided by the Authority critically.

The biggest points of uncertainty were the provisions provided by the Authority beyond the statutory requirements: compliance with these provisions is not mandatory, while the consequences of non-compliance are unclear. Another problem was the general nature of the Recommendation: different lines of business require different approaches (for example, the term "least expensive offer" makes sense in the case of loans, but is meaningless in the case of

deposits). Although the Recommendation declared that it built on customer awareness, the specific proposals seemed to assume underinformed, careless customers.

In relation to the specific recommendations made in the proposal, we raised the following points:

- ↳ While recognising that an extensive loan contract may contain hard-to-comprehend legal texts, the recommendation to provide a one-page summary of the essence of the provisions of the contract seemed inexpedient, given that depending on the case, different provisions may be emphatic or become important at a later stage. Hence, emphasising or omitting a particular provision of the contract may at a later stage give rise to valid complaints.
- ↳ We did not support the recommendation that in the absence of any specific request from the customer, the least expensive and least risky product should be offered. Firstly, the least expensive product is not always the least risky one. Secondly, it may happen that the most expensive product is the best suited to the customer's needs (and also the least risky one).
- ↳ Banks disagreed with the Supervisory Authority's recommendation that the measures to be applied by the bank in an extraordinary situation be stipulated in the loan contract: extraordinary future events cannot be predicted (that is, the necessary measures cannot be determined in advance). Also, recent examples (flooding, the red sludge disaster) had shown that banks were flexible in responding and helping customers in extraordinary situations.

The Supervisory Authority organised a meeting with a wide range of participants, including banks, to review the comments received. At the meeting, the Supervisory Authority outlined how it saw the legal status of the proposed recommendations: the Supervisory Authority would welcome the implementation by market players of the recommendations. Should market players fail to implement the recommendations, the Authority would consider issuing a regulation. All comments provided were addressed at the meeting and the Supervisory Authority promised to give us the opportunity to review the revised version of the Recommendation before issuing it.

3. Notary fees

The Association initiated consultations with the Hungarian Chamber of Notaries on application and interpretation issues related to fees charged by notaries in the context of the widened scope of authority of notaries. The consultations were aimed to clarify the following issues:

- ↳ no multiple fees to be charged in the case of several debtors;
- ↳ past due interest should not be included in the base for the calculation of fees for writs of payment, given that pursuant to the relevant legislation, interest is deemed as an additional amount.
- ↳ the incorporation in legislation of transfer of funds by notary order should be considered,
- ↳ in amending mortgage loan contracts (changing the contract currency, changing the collateral, extending the loan period, etc.), a reduced lump sum fee, or an hourly fee should only be charged rather than the full notary fee.

3.1 Notary public foreclosure decisions: procedural fees and number of copies of authentic documents to be attached

In previous court practice (in accordance with Section 40 the Stamp Duties Act), courts charged only one procedural fee even in those cases where several debtors were involved.

There are divergent court decisions on this issue. Banks have several court decisions providing that only one procedural fee may be charged, but there is also a number of cases, where contrary decisions have been made, sometimes within the same court.

The Hungarian Chamber of Notaries initiated with the Ministry of Justice several months ago a regulatory amendment in relation to those cases where there are several debtors involved and the creditor launches a foreclosure procedure against each of them. The Chamber of Notaries proposed that the base fee payable to the notary for launching the foreclosure procedure (as per section 31/E of the Act on Judicial Distraint), currently being HUF 5,000, should be increased. It also proposed that a certain percentage of the fee payable for the foreclosure procedure to be launched against the first debtor be payable for the second, third and subsequent debtors, with the total amount of fees (for example in the case of 8 or 10 debtors) not to exceed a certain percentage of the fee payable for the first debtor. (No specific amount was specified).

In the meantime, the issue of the number of copies of authentic documents to be attached to a foreclosure request was settled by Ministry of Justice Decree No. 28/2010. (XII.31.) amending Decree No. 37/2003. (X.29.) on notary administrative rules. The new decree provides that two authentic copies should be attached as a prerequisite for a foreclosure decision to be issued.

As a favourable development concerning the relevant court practice: at their meeting on March 9, 2011, the Heads of Civil Law Colleges took the position that in the case of several debtors, only one procedural fee should be paid.

3.2 Procedural fees for writs of payment

The Hungarian Chamber of Notaries is of the view that all claims with specified amounts in the request for a writ of payment, that is, the principal, as well as any overdue interest on the principal are included in the main claim. Consequently, all these amounts should be included in the calculation of the procedural fee. Also, in the electronic form used by the Chamber of Notaries, the system automatically adds overdue interest to the principal.

However, pursuant to Section 44 (1) of Act L of 2009 on Writs of Payment, the base of the procedural fee is the amount of the monetary claim as of the date of institution of the proceeding, without any additional amounts. The issue is still being discussed.

3.3 Fees payable for loan contract amendments (loan trade-offs, changing the loan currency)

In the case of foreign currency home loan borrowers in distress, the loan contracts often need to be amended (for changing the loan currency, extending the loan period, changing the collateral, or providing additional collateral). The Association had earlier submitted to the Ministry of Justice a proposal for specific fees to be charged for such amendments.

Leaders of the Chamber of Notaries say these fees cannot be set based on the transaction value, as the transaction value has no relevance in these cases, the notary's action in these cases is the amendment of the contract, which is done on an hourly fee basis. The relevant regulation should be changed in this respect, as well.

The discussion on the issue continued at the Ministry of Justice and the Chamber of Notaries and the Association also held several rounds of written and verbal consultations on the issue. These consultations are still in process.

4. New legislative concept for the regulation of intermediaries

The Hungarian Financial Supervisory Authority drafted a comprehensive concept for the uniform regulation of bank, insurance and voluntary pension fund intermediaries. We consulted on the proposal with members and the Association's Intermediaries Working Group also reviewed the proposal. At the end of January, we held a meeting with the drafter of the proposal, Dr József Banyár and his team.

In our written comments and also at the meeting, we pointed out that the proposed revision of the regulations was untimely. First, the impacts of the recently enacted new regulations should be assessed. Based on this assessment, a decision could be made whether a revision to the regulations was needed. The proposal failed to present the practical or legal reasons for a uniform regulation. It is questionable whether the regulation of all these divergent areas under a single law would bring the expected results. We proposed that before going on with the proposal, the drafters should wait for the results of related legislative work, such as the new Civil Code, the revised EU Directive on insurance intermediaries and the proposed EU Directive on credit agreements relating to residential property, all addressing the activities of intermediaries in detail.

We also proposed that in view of the complexity of the work and to ensure consistency with other related laws, the competent Ministries should be involved in the drafting process. We submitted detailed comments on the professional aspects of the proposal to the Hungarian Financial Supervisory Authority. The Association of Hungarian Insurance Companies and the financial enterprises involved in the review provided similar critical comments on the proposal.

We seized the opportunity to draw the Hungarian Financial Supervisory Authority's attention of to some undesirable phenomena related to the activities of intermediaries, such the activities of "credit relaxation" agents, acting without a supervisory licence and promising borrowers in distress to arrange (for a significantly high fee) for a substantial relaxation of the loan terms with the creditor bank.

5. Assessment and revision of the Association's Recommendation on bank account switching

In accordance with the EBIC's self-regulation framework, the Association's Board Recommendation No. 6/2009 on bank account switching took effect on November 1, 2009. The Recommendation aims to facilitate bank account switching by customers in respect of the two most typical payment orders under a one-stop system.

In the first eight months (November 2009 - July 2010), banks received 1800 requests for bank account switching, 55% of which were duly concluded. One-third of the requests filed involved a full switch (not just to the transfer of certain services, such as direct debits or standing order transfers, to the new bank, but the termination of the old bank account). Only every tenth of these requests was concluded. The main reason for this was that the simplified termination process cannot be applied if the old account is associated with a bank card.

More than a year after its adoption we reviewed the Recommendation with specialists from banks and, based on the above statistics, amended it so that the customer does not have to open a new bank account to start the bank account switching process: the payment orders covered by the Recommendation can be transferred between existing bank accounts.

6. Revision of the Code of Conduct for retail lending

Regulatory changes, in particular those affecting mortgage lending, enacted since the adoption of the Association's Code of Conduct for retail lending prompted the need to review the Code. The review was also requested in a letter by the President of the Hungarian Financial Supervisory Authority. The need for a review of the Code was also substantiated by the Supervisory Authority's Q2 2010 report on consumer protection risks, concluding that the regulatory benefits of the Code today only apply to non-home credit and financial leasing contracts.

Based on the Association's Board's decision, we set up a working group to update the Code. In the first round, the working group reviewed the current text of the Code. Given that there are 271 signatories to the Code, it should be decided how the revision of the Code should be managed, that is, an appropriate procedure will have to be devised.

7. Ombudsman's report

The Civil Rights Ombudsman conducted an investigation on the exercise of fundamental rights in financial legal relations, in particular, in relation to responsible lending and unilateral contract amendments. The Association provided a detailed response, presenting the developments in legislation, the relevant provisions of the Code of Conduct for retail lending, and the related banking practices. The Ombudsman report No. AJB-2183/2010, issued in February 2011, analyses in detail the latest pieces of legislation related to consumer protection, customer information and credit risk mitigation. The report establishes that the customer information requirements are overcomplicated, fail to meet the purpose and impose unnecessary burdens on customers and market players. In relation to the regulations on responsible lending, the report criticises the relevant government decree requiring financial institutions to assess the customer's creditworthiness based on unverifiable pieces of information. In the absence of a comprehensive credit information system, the customer's creditworthiness cannot be verified.

In his report, sent to the government, the Civil Rights Ombudsman invited the government to mandate financial institutions, by amending the relevant regulations, to provide customers with meaningful information, focusing on the legal relations and risks involved in the transaction. The Ombudsman proposed the creation of a comprehensive credit information system, the development of a personal bankruptcy framework, and the portability of government home subsidies. He also requested the government to make the development of financial literacy a priority.

8. Corporate governance

The European Banking Federation compiled a report on corporate governance regulations affecting financial institution in the various member states. In the summary of the Hungarian regulatory framework, including the Companies Act and the Credit Institutions Act, we presented the relevant regulations on the composition and responsibilities of boards of directors of joint stock companies, the accountability systems, the organisational solutions for risk management, the role of external auditors, the powers of supervisory authorities, the responsibility of shareholders and institutional investors and the regulations on remuneration policies.

9. Enhancing payment services - implementation of intraday settlements in Hungary

Pursuant to the Payment System Council's decision of June 23, 2010, intraday settlements (InterGIRO 2 - IG2) are expected to be introduced in Hungary on July 1, 2012. The InterGIRO 2 system will allow the same-day execution of electronic retail payment orders, within the same bank and between banks. Currently, the execution time for interbank credit transfers, depending on the time of receipt of the payment order is two or three days. Pursuant to MNB Decree No. 15/2010, effective from July 1, 2012, electronic payment orders should be executed within 4 hours. Implementation of the new system, involving major development projects, will be supported by a Project Management Committee and a Banking Working Group. The Association is represented in both bodies. The Banking Working Group solicited guidance on several occasions from the Project Management Committee and the MNB during the development of the required system solutions. To ensure that the system benefits customers, further consultations will be needed with the MNB concerning the rules for the execution of payment orders received after the cut-off time.

10. Debate with the MNB regarding a proposed new regulation on cash distribution and processing

With no agreement reached in 2010, the debate with the MNB regarding the mechanical processing of banknotes continued.

In his response to the Association's letter, the MNB's Governor pointed out that MNB was determined to combat counterfeiting by using the most advanced means available. However, he expressed the MNB's willingness to take account of the results of a potential impact study or survey to be conducted before introducing the requirement of mechanical processing, entailing extra costs for banks.

The issue was reviewed with banks' specialists and also discussed by the Association's Board. It was concluded that it did not seem expedient to continue to challenge the MNB's position of the need for automatic processing with a view to combating counterfeiting, nor would it be expedient or desirable to undertake a major, complex and costly, impact study. Accordingly, the Board authorised the competent working group to negotiate a compromise solution with the MNB, taking into consideration the aspects of both parties. Thus, after several months of discussions, agreement was finally reached: with a view to efficiently combating counterfeiting, branches with high cash transaction volumes may only be supplied with mechanically processed banknotes. Also, tills with high cash transaction volumes will have to be equipped with counterfeit detection lamps. To reduce the financial burden on banks, the

required development projects may be implemented over a longer period of time. Branches and tills with low cash transaction volumes will be exempted from the above requirements.

The review of the MNB decree reflecting the above compromise agreement was concluded, the decree is expected to be issued in the middle of the summer.

11. Proposed new MasterCard payment service (MoneySend)

A number of concerns were raised concerning MasterCard's new payment service, **MoneySend**:

- ↳ the new payment service is unsuitable for monitoring the transaction, given that the receiving bank does not know the details of the sender;
- ↳ consequently, the receiving bank cannot tell the recipient who sent the money credited to his/her account;
- ↳ neither the sending bank nor the sender can be properly identified or checked for blacklisting;
- ↳ not all countries that may participate in MoneySend have an anti-money laundering legislation equivalent to that in force in Hungary.

To dispel these concerns, we held several consultations and solicited the Hungarian Financial Supervisory Authority's position on the issue. No reply was received from the Supervisory Authority until the closing date of this report.

12. Supervisory reporting

In addition to changes in the annual regular supervisory reporting requirements, the requirements for consumer protection have also changed from 2011. The underlying tables in the programme helping customers to choose between the various loan and leasing products have been restructured. Also, the Supervisory Authority has introduced a new online data transmission system, called ERA. The new system has entailed changes in the relevant processes. The checking and maintenance of the data and adaptation of the reports to the new requirements will entail extra tasks for all banks. During the relevant consultations, a number of issues were clarified and the implementation date of the new system was extended.

At the beginning of the year, we submitted to the Supervisory Authority a set of amendment proposals to the Authority's proposed decree on reporting requirements on high remunerations. In accordance with the relevant EU laws, from May 31, 2011, credit institutions and financial enterprises will be required to report the number of those executive and employees whose annual remuneration is equal to or in excess of HUF 300 million. The feedback received from members shows that in the case of most members, there are no executives or employees with remunerations reaching this limit.

In March, a consultation was launched on COREP and on the proposed reporting package for investment services. During the review of the proposed decrees we submitted a number of proposals and adjustments to make the provisions of the decree more specific. We pointed out that the proposed changes would again require major IT developments. Accordingly, we requested that a three-month preparation time be allowed from the finalisation of the relevant decrees. As an initial achievement, the Supervisory Authority promised to revise the proposed

decrees to take account of the proposals made by banks and we expect to have a positive response regarding the implementation date, as well.

The Supervisory Authority aims to strengthen its consumer protection powers by interconnecting its Deposit and Savings Product Selection Programme with its Loan and Leasing Product Selection Programme. The development of a database for an Account Selection Programme is expected to be started soon in cooperation with the Association. At the beginning of the year, consultations were also held on the Authority's new deposit product selection programme. The relevant reporting templates have been finalised, the development of the IT programme is now in process. The system will be uploaded by the beginning of May and available for external users by June.

13. Taxation issues

Section 82 of Act CLIII of 2010 provides rules allowing for the repatriation of funds held in foreign accounts under a preferential tax rate. In accordance with the relevant provisions of this Act, the Hungarian Financial Supervisory Authority appointed the financial institutions that can be involved in this process, entailing tax liabilities. Since there are a number of points where the application of the legislation is unclear for banks, we held a consultation with specialists from member banks and requested a ruling from the Ministry for National Economy.

We also approached the Tax Office with a request (also indicated several times to the Ministry for National Economy) for the Tax Office to publish on its website a list of those taxpayers that have chosen to be subject to VAT for the purpose real estate sale in the fiscal year in question, or to initiate with the legislators the creation of such a public database. The creation of such database would substantially simplify tax administration. Banks face substantial difficulties in enforcing their mortgages in cases where the owner of the real estate is subject to VAT. Specifically, the problem is that by the time the bank's collection actions reach the point where, by enforcing its mortgage, it can put the real estate on sale, the customer's willingness to cooperate diminishes and the bank is unable to obtain meaningful information from the customer as to his/her choice of being subject to VAT on the sale of the real estate. In this case, pursuant to Paragraphs (5) and (6) of Section 142 of the VAT Act, the bank may request information from the Tax Office and the Tax Office should provide this information without delay. However, in practice, the provision of this information is difficult and time-consuming and almost always extends beyond the deadline for tax payment, as a consequence of which banks are unable to meet their relevant tax obligations in time.

14. Expected changes in the international accounting rules for the netting of financial assets and liabilities

The international and American accounting standard-setting bodies, the IASB and the FASB at the beginning of the year published for comment a joint proposal for the offsetting of financial assets and liabilities. The current differences between the IFRS and US GAAP approaches to the netting of financial assets and liabilities can result in significant differences in total assets. The joint proposal aims to establish a common netting approach. The difference stems from the presentation of derivative assets and liabilities as a single net amount or two gross amounts. This significantly reduces comparability of the figures, particularly in the case of financial institutions.

In developing the proposal, an important aspect was to determine the conditions under which the financial statement provides the most useful and most appropriate information. Although users show no preference for either method over the other and consider the net and the gross approaches as equally useful, they urge for a common approach. The recent financial crisis has strengthened the need for the convergence of the requirements for offsetting financial assets and liabilities.

Under the proposal, an entity would be required to offset a recognised financial asset and a recognised financial liability when it has an unconditional and legally enforceable right of set-off and intends either to settle the asset and liability on a net basis or to realise the asset and settle the liability simultaneously. The proposal clarifies that the offsetting criteria apply whether the right of set-off arises from a bilateral arrangement or from a multilateral arrangement. The proposal also clarifies that a right of set-off must be legally enforceable in all circumstances (including default by or bankruptcy of a counterparty) and its exercisability must not be contingent on a future event. In all other circumstances, an entity's recognised financial assets and recognised financial liabilities are presented in the balance sheet separately from each other, according to their nature as assets or liabilities. The proposal also requires the reporting entity to disclose all other arrangements related to their rights of set-off (such as collateral agreements) to enable users to understand the effect of those rights and arrangements on the entity's financial position.

The proposal primarily affects entities using the US GAAP, as it changes the rules for offsetting derivative transactions and reporting cash collaterals and repurchase agreements in the financial statements.

The proposal is basically in line with IAS 32 Financial Instruments: Presentation. Accordingly, the changes will primarily affect the level of detail of the disclosures and increased emphasis will be put on the disclosure of the rights of set-off and presentation of the related quantitative information. The proposal does not provide for any implementation date, this will be decided at a later stage after assessing the comments received.

The European Banking Federation set up a working group to work together with the ISDA with a view to developing a joint position on the proposal.

15. Hungarian Financial Supervisory Authority circular on banks appointed to receive off-shore funds

The Hungarian Financial Supervisory Authority, in its Circular 3/2011 appointed ten banks to receive funds repatriated from foreign accounts (off-shore funds). This was done without any prior consultation with banks and it is unknown why those particular ten banks were selected. Given that the requirement of customer due diligence applies to these transactions as well; a number of issues need to be clarified. It would be unfortunate for a bank, which is otherwise expected to monitor suspicious transaction, to have to be involved in legalising potentially fraudulent money.

II. ASSOCIATION EVENTS, WORKING GROUPS

1. EBF Board and Executive Committee Meetings in Budapest

The European Banking Federation traditionally holds its board meetings in the member state holding the EU presidency. Accordingly, the EBF Board and Executive Committee held their meetings on April 7 and 8 in Budapest. The meetings were hosted by the Hungarian Banking Association.

The European Banking Federation is one of the main professional organisations of the European banking industry. It represents the interests of some 7,500 banks in 31 countries, with around 3.2 million employees. Its senior officers include the presidents of national banking associations (CEOs of major European banks) and the operational heads of national banking associations.

The meeting was attended by nearly 70 leading European bankers and financial experts. András Kármán, State Secretary of the Ministry for National Economy welcomed the participants on behalf of the Hungarian government. At the EBF Board Meeting, Dr Júlia Király, Deputy Governor of the MNB held a well-received presentation on the Hungarian banking sector and on the challenges of monetary policy. Dr Károly Szász, President of the Hungarian Financial Supervisory Authority gave a presentation drawing a parallel between immediate tasks for the European and Hungarian supervisory authorities. Members of the Executive Committee found the presentation interesting and useful.

At their two-day meetings, the EBF's governing bodies reviewed issues related to proposed European reforms aimed at preventing future financial crises and the European supervisory architecture. Special emphasis was given to the key objective of stability: the impacts of the proposed measures, including the calibration and timing of Basel III, should be assessed against this objective.

2. Meeting of the EBF Consumer Affairs Committee in Budapest

At its meeting held in Budapest, the EBF Consumer Affairs Committee heard a briefing from the competent Head of Department of the Ministry for National Economy on the Hungarian Presidency's priorities in the area of consumer protection and on related current issues. The briefing was followed by a questions and answers session. Members of the Committee expressed their thanks to both the Ministry's representative and the Association for the informative and professional presentation and answers.

The Committee reviewed three main issues:

- ↳ The drafting of a self-regulation on bank account fees to make the fees comparable is now in progress at an accelerated pace. The EU authorities and consumer organisations accepted that the self-regulation should primarily be implemented at the national level. Hopefully, an extension of the date for implementation at the national level will also be agreed. However, disagreement seems to persist regarding the provision to customers of an annual statement of total fees charged: banks regard it as an unnecessary service that is difficult to implement. However, the EU counterparts consider it as a key element.

↳ Although few members were familiar with the latest version of the proposed EU Directive on mortgage credit, according to reports, the provisions objected to earlier (the mandatory rejection of the loan application in the case of a negative credit rating, provision of advice on the suitability of the product) continue to be included in the proposal. The EBF, through its members, seeks to play an active role in the review of the proposed Directive.

↳ There was wide agreement among members regarding the proposed EU Directive on access to a basic bank account. Banks are of the view that there is no need for such a product, as such services do exist in almost all member states. Those not using this service deliberately keep away from publicity. Nevertheless, there is a lot at stake in the review process and the industry will treat the issue accordingly.

On the day before the meeting, members of the Committee attended a sightseeing tour and a dinner hosted by the Association.

3. EBF Fiscal Committee delegation visit to Budapest

Leading experts of the EBF Fiscal Committee visited Budapest in early February to exchange views with representatives of the Hungarian government, holding the EU presidency, on taxation issues affecting banks in Europe. The discussions were focused on the long-discussed modernisation of the VAT Directive, but the EBF delegates took the opportunity to seek information on other issues, as well.

In relation to the VAT modernisation process, primarily focusing on financial and insurance services, the EBF delegates pointed out that the non-deductibility of VAT is a substantial burden for the industry. They stressed that in addition to making the definition of financial services more specific, there was a need to improve on a number of other provisions as well. In relation to definitions, it is particularly important and desirable that derivative transactions, outsourcing and the transfer of financial contracts remain VAT exempt (this is also warranted by the contents of these activities). The EBF delegates made proposals for further adjustments to the rules for cost sharing (referred to in Hungarian VAT legislation as Cooperative Community) and the option to tax (the option to make financial services taxable, now introduced in six member states and mainly applied to B2B supplies). The EBF delegates drew attention to the divergence in national practices due to the lack of precise and detailed rules.

The EBF delegates also touched upon the issue of a European bank tax, pointing out that this would put the European banking sector at a competitive disadvantage to other sectors and to non-European banks. The Regulatory restrictions affecting the banking sector put an extremely heavy burden on the banking sector and the changes, such as the new capital adequacy framework, the increased reporting requirements, new accounting standards (IAS 39 replaced by IFRS 9, with more stringent valuation and impairment rules) and the FATCA in the U.S. (with new and highly detailed reporting requirements being imposed from 2013), entail extremely high costs. Hence, the issue of bank tax should be addressed in a complex way in conjunction with the legislation on VAT (the objective is to make VAT deductible in the financial sector) and the creation of a resolution fund.

The revision of the EU Savings Directive and the U.S. FATCA were also addressed at the meeting. The EBF delegates said they considered the burden imposed by the FACTA from 2013 to be extremely high in terms of both administration and costs.

The Hungarian decision-makers said they understood the EBF's points, would look into the issues raised by the EBF and were looking forward to receiving the EBF's proposals. They also said there was strong political demand in Europe for the imposition of a European bank tax, but it was unknown when a decision would be made. Should a European bank tax be imposed, Hungary would abide by its promise and replace the current bank tax with the EU tax. They said that the revision of the Savings Directive was expected to be concluded in the first half of 2011, the drafters were currently working on amendments to the scope of the Directive and on transitional provisions of the legislation. In relation to the FATCA, few comments had been received from member states. Should any action become necessary, it would be for the European Commission to take up the matter with U.S.A. In relation to some of the issues raised by the EBF delegates, it was mentioned that those would require a decision by the ECOFIN.

The EBF delegates found their meeting with representatives of the Hungarian presidency positive and useful.

4. Consultation on operational issues related to the Central Credit Information

The main topic of this consultation was the experience of lawsuits filed for the deletion of credit information from the system. 17 lawsuits were filed in 2010, most of them concluded in favour of the information provider. However, in eight cases, the court ordered the credit information to be deleted. The lawyer representing BISZ Central Credit Information (BISZ Zrt.) in the lawsuits, invited to the meeting, said 102 lawsuits had been filed since 1995. There were three banks, against whom more than 10 lawsuits had been filed, each. He explained that BISZ Zrt. basically had no say during the lawsuits; however, the two organisations involved (BISZ and the creditor bank) are closely interconnected during these cases. During the lawsuit, the court may order the suspension of information processing. In this case, the credit information should be blocked within two days. If the court of first instance orders the deletion of the information, the suspension of information processing remains in force until the decision becomes effective. BISZ has to participate in the lawsuit with a view to ensuring that the court's decision is implemented. In this respect, certain provisions of the relevant legislation should be made more specific.

Legal counsels from member banks explained that the main problem was not with the deletion of the information: banks delete the information right after the inquiry has been filed. A part of the lawsuits is filed as lawsuits for damages. During these cases, courts normally decide based on the principle of strict liability, regardless of any actual damages being incurred or regardless of the size of such damages, taking it as a fact that being registered in the Central Credit Information System entails disadvantages. With thorough legal advocacy, the liability for damages in lawsuits filed for privacy violation can be averted. However, in cases filed for rejection of the loan application, the creditor's position is harder to defend. The judicial custom could be improved if more petitions for review by the Supreme Court were filed.

Participants in the meeting analysed in detail a decision made by the Supreme Court in a deletion lawsuit.

As another issue to be solved, the question was raised whether a customer may request the deactivation of his credit information in the event the claim is sold and a new instalment

payment is agreed on. The issue requires further consultations with BISZ Zrt. and the Hungarian Financial Supervisory Authority.

5. Consultation with the Hungarian Financial Supervisory Authority

Following an article published in the Association's E-Newsletter, the Hungarian Financial Supervisory Authority's Market Supervision Department invited us to a consultation, where we reviewed the possibilities for eliminating businesses that are not illegal but are not subject to supervision and often cause damages to customers.

6. Initiation of partnership agreements with ministries

Pursuant to Act CXXXI of 2010 on public participation in the drafting of legislation, the minister responsible for the drafting of legislation should develop strategic partnership agreements with organisations that are capable of representing wide groups of society in the various areas of legislation. The Hungarian Banking Association has always sought to develop cooperation with the various government bodies, based on mutual interests and understanding. Accordingly, we initiated the development of strategic partnership agreements with the Ministry for National Economy, the Ministry of Administration and Justice, the Ministry for Rural Development, the Ministry for National Development and the Ministry for National Resources.

In a separate letter, we requested the Ministry of Administration and Justice's Ministerial Commissioner responsible for drafting the new Civil Code, Dr László Székely, to involve the Association in the review process.

We received encouraging responses from the organisations approached. The Association concluded partnership agreements with the Hungarian Financial Supervisory Authority and the National Deposit Insurance Fund.

7. Cooperation agreement with the National Police Headquarters

The Association signed a cooperation agreement with the National Police Headquarters on April 1. The signing was attended by the Minister of Interior. The Association and the Police has had a well-functioning cooperation agreement in place for many years. This agreement has greatly contributed to successful crime prevention and detection. The new agreement takes account of all those developments over the past five years, such as the increase in electronic crime or phishing, that have necessitated the review of the framework and contents of cooperation. Pursuant to the new agreement, the Association and the National Police Headquarters will cooperate in the prevention and detection of white-collar crime and in developing the contents and techniques for police requests for information from banks.

8. Meeting with leaders of the Association of Hungarian Insurance Companies

At the end of February, we held a meeting with new leaders of the Association of Hungarian Insurance Companies, Dr Daniel Molnos, Secretary-General and Dr Csaba Kerékgyártó, Head of the Non-Life Insurance Section, to exchange views on current issues related to the regulation of intermediaries and home loan related insurance contracts.

9. Retail banking conference

Associates of the Association held presentations at the Retail Banking 2011 conference organised by IIR Hungary in March. The presentations addressed issues related to new developments in the regulations on retail banking, rescuing borrowers, the eviction moratorium, and free basic accounts.

10. Meeting on agricultural lending

At the Association's request, the State Secretary responsible for agricultural lending gave a briefing to interested banks on agricultural subsidies available in 2011. The State Secretary said major changes in the subsidies system were expected from 2012. Questions raised by banks were answered by the State Secretary and his associates.

The Association held a consultation with competent officers of the Ministry for Rural Development on the Agricultural Working Capital Loan Scheme.

Banks were given a briefing on preparations for the launch of Agricultural Széchenyi Cards. A detailed consultation on the scheme will be held once the key elements of the scheme are approved by the government.

The Ministry for Rural Development initiated amendments to the MFB Food Industry Bank Guarantee Programme, as representatives of the milling industry had indicated that due to what they considered to be high interest rates and guarantee fees, they were unable to finance their grain stocks. At the meeting held on the issue, the MFB's representative promised to present a specific proposal in due course.

11. SME lending

At the Association's initiative, leaders from the National Development Agency and Venture Finance Hungary gave a briefing on priorities of the New Széchenyi Plan and related funding issues.

12. Lending issues related to changes in energy laws

Banks set up an ad hoc working group to review the impacts on banks of new energy laws and changes in the mandatory electricity purchase scheme. From July 1, 2011, combined heat and power plants will no longer be subsidised. The change affects 149 power plants, which may face financial difficulties and problems in repaying their loans.

Banks raised that the Association's Board should request the Minister for National Economy to give the Association the opportunity to participate in the drafting of the relevant legislation. The issue is particularly sensitive also because if, due to financial difficulties, some of the companies affected were forced to terminate their loans, then in addition to the problem of non-repayment of the loans, households and businesses in the cities affected would be left without an electricity supplier. The unpredictable regulatory environment would cause uncertainty among investors and among banks, the problem might escalate and the implementation and financing of future energy investment projects could become questionable.

13. Meeting of banks' communications officers with media representatives

The Association organised, for the fourth time now, a meeting for banks' communications officers and prominent financial and business journalists. This forum provides the Association the opportunity to present the most important tasks ahead and to provide a brief assessment of the performance of the banking sector and the key issues facing the industry. Banks and journalists both consider the event as a useful opportunity to build professional and personal relations in an informal setting.

14. Association Working Groups

14.1 General Compliance Working Group

At its first meeting in 2011, the Association's General Compliance Working Group hosted Zoárd Gázmár, Managing Director of the Hungarian Financial Supervisory Authority (a former colleague), who presented the Supervisory Authority's new structure, policy and key priorities.

14.2 Payments Working Group

The Association's Payments Working Group meets on a monthly basis. The Working Group addressed practical issues arisen during implementation of the relevant laws. The Group, *inter alia*, reviewed possible solutions for the implementation of MasterCard's new services to be introduced on a mandatory basis also in Hungary (MoneySend; changing the PIN code and making account balance inquiries at foreign ATMs). The Working Group consulted on the potential solutions with the Cards and Anti-Money Laundering Working Groups. Based on the discussions, the Working Group concluded that no common action could be agreed. Consequently, it will be for the individual banks to agree with MasterCard on the issues arisen and on the extension of the deadlines.

At the request of the Working Group, the Hungarian Financial Supervisory Authority's Managing Director, Máté Siklósi gave a briefing on the implications of the new Act on the Hungarian Financial Supervisory Authority for banks' approach to consumer protection issues and banks' obligations concerning the setting up and operation of the new Financial Reconciliation Body and the related requirements. The Managing Director also presented the four categories of supervisory recommendations (Recommendation of the President of the Hungarian Financial Supervisory Authority, Recommendation of the Supervisory Council, Recommendation of the Supervisory Authority and other Recommendations). He explained the legal nature and normative contents of the recommendations, the verbatim quotation of the reference in the complaint procedure, the rules for compliance with the recommendations, the sanctioning of non-compliance, the updating of the recommendations and their repeal. He reviewed the cases where the Supervisory Authority would consider the individual rulings warranted and applicable as common wisdom to the banking community as a whole or to the individual banks. He also presented the consumer protection liaison's responsibilities, powers, qualification requirements and the expectations regarding the liaison's activities and their control.

In relation to the problem arisen in connection with the Hungarian Post Office, the Working Group agreed to solicit the position of the MNB's Payments and Securities Settlements unit regarding the relevant section of the postal payments intermediation services agreement as to

the legality of the Post Office's practice of refusing the further handling of payment orders rejected by banks' IT systems due to invalid bank account numbers or other inadequate information. No reply was received until the closing date of this report.

14.3 Cards Working Group

The first meeting of the newly set up Cards Working Group was attended by representatives from MasterCard, including MasterCard's MoneySend specialist, Brian Morris. The guests answered questions raised by banks regarding the MoneySend service. Brian Morris's presentation addressed all details of the service and was extremely useful.

The deadline set by MasterCard for the implementation of the MoneySend service and the need to develop a common complaint handling procedure due to the unexpected wind-up of Aeroviva made it necessary to convene an extraordinary meeting of the Working Group. Based on the lessons learned from Aeroviva's failure, an ad hoc working group was set up to develop a common procedure to be followed by banks in the case of the failure of a merchant or service provider. The procedure could be adopted if all Hungarian banks support it and each bank so advises MasterCard. The meeting was also attended by the representative of VISA to Hungary, who gave a presentation on the proposed VISA Marketing Forum. He also informed participants on VISA's new Hungarian website, now under construction and on VISA's plan to put together a manual to aid police in the detection of frauds. He also drew attention to the importance of joining forces in promoting contactless card acceptance.

14.4 IT Security Working Group

An associate of Erste Bank notified us on March 11 on a phishing scam using a name very similar to the Association's name ("MAGYAR NEMZETI BANKSZÖVETSÉG" - "HUNGARIAN NATIONAL BANKING ASSOCIATION"). We sent a warning to members' CEO secretariats and published the text of the phishing letter on our website, along with a statement that the Hungarian Banking Association never requests information of the kind asked for in the letter. In the statement we also requested card holders not to provide the details requested. We reported the phishing scam to the police.

14.5 Human Resources Working Group

The Human Resources Working Group consulted several times with the competent leader of the Hungarian Financial Supervisory Authority and the competent officer of the Ministry for National Economy on the proposed Government Decree on remuneration and the related supervisory recommendation. Members of the working group made several comments on the proposals. The proposed government decree would be based on the CEBS guidelines, which, in the wake of the financial crisis, are aimed at limiting excessive executive compensation and bonuses, increasing the share of performance-related pay and reducing remuneration payments in respect financial institutions that are significantly larger in size than those operating in the Hungarian banking sector. Paying non-cash compensation (in equity or securities) is especially difficult in the case of Hungarian banks. Also, the interpretation of deferral and the definition of the scope of those subject to the proposed decree and the related Recommendation raise questions. The drafters agreed that the issues raised by banks were valid and promised to endeavour to take them into account in the legislation. The legislation is delayed, which means that banks will have little time to prepare for the implementation of the legislation from June.

14.6 Electronic bailiff inquiries

Members indicated that despite the fact that the electronic inquiry system established between bailiffs and banks in 2009 is fully operational and implemented by most banks, there are still many bailiffs, who have not switched over to the new system and continue to send their inquiries in hard copy form. The processing of these inquiries makes banks' work difficult. We raised the issue last year with the Chamber of Bailiffs. Now, we sent the Chamber the list of those bailiffs who have not switched over to the new electronic inquiry system. We once again requested the Chamber's assistance in convincing the bailiffs in question to switch over to the new system.

14.7 New working group on the proposed EU self-regulation on bank account fees

The drafting of the proposed EU self-regulation aimed at ensuring the comparability of bank account fees, strongly supported by the EU Commission and the EU Consumers' Organisation (BEUC) and managed by the EBIC, in 2011 arrived at a stage where specialists at the national level should be more actively involved in the process.

At the Association's invitation, specialists from some 10 member banks were delegated to the new working group, whose first task was to answer the EBIC questionnaire aimed at assessing the main decision points of the proposed self-regulation.

Pursuant to the proposal, each national banking community would select about ten current account-related services under common names and publish the relevant fees in a common format. The common name and format would ensure the comparability of the fees.

The new working group had to decide on how to relate to the similar proposal of the Hungarian Financial Supervisory Authority for a common disclosure format. It was decided that when the proposed EU self-regulation reaches a final stage, the Association should start discussions with the Hungarian Financial Supervisory Authority with a view to adopting the self-regulation developed by the Hungarian banking community.

The working group also agreed to

- ↳ select ten current account services typical for the structure of payment transactions in Hungary (e.g., credit transfer, cash withdrawal, direct debit),
- ↳ clearly define these transactions, by involving consumer organisations, as required by the relevant EU self-regulation principles,
- ↳ try to determine the typical amounts and methods of using these services (as is done in the case of APR calculations) with a view to ensuring the unambiguous identification of each service and its price.
- ↳ for current account packages, the EBIC methodology will be used,
- ↳ the working group considers that 18 months should be allowed from the adoption of the proposed self-regulation at the EU level for its implementation at the national level. (First, a national self-regulation framework will have to be adopted, followed by sufficient time for its implementation).
- ↳ this period may be longer should the EU self-regulation require the provision to customers of an annual statement of total fees charged.

The answers provided by the working group to the EBIC questionnaire were sent to EBIC.

ANNEX**INTERNATIONAL COOPERATION: REGULATION, SUPERVISION****EUROPEAN BANKING FEDERATION****1. Regulation****1.1 Basel III - CRD4****1.1.1 CRD4**

The latest version of the European Commission's CRD4 proposal is delayed and expected to be completed by the summer/autumn of 2011. The proposal gives special attention to European specificities, such as the definition of capital (there is no commonly agreed definition in the EU for common equity), the home/host aspects in the liquidity framework, and grandfathering¹. The results of the quantitative impact study assessing the GDP impacts of the proposed regulatory package will be published together with the proposal. The comprehensive impact study assessing the combined impacts of the deposit guarantee scheme framework, the crisis resolution framework and Basel III will be published together with the crisis resolution framework. According to current plans, the final text of CRD4 is expected to be agreed by the end of 2013.

The European Commission envisages to enact CRD4 partly under a regulation and partly under a directive. The regulation would contain the rules applicable to banks (except for the countercyclical buffers). This means that some of the provisions of the CRD would be transferred into the regulation, which is directly applicable. The directive would primarily contain the rules applicable to supervisory authorities (such as the Pillar 2 rules). This regulatory concept is currently under debate, given that member states are opposed to full harmonisation. The European Commission is determined in its objective to remove all national options and discretions in the CRD, with the exception of those related to mortgage exposures (weights, LTV ratios). A major change in the Single European Rulebook in relation to national options and discretions may be the abolition of the options for the weighting of exposures to banks under the standardised approach: option 1, linked to the sovereign rating of the country will be eliminated, and option 2, under which a 50% weight is applied to unrated bank counterparties will become a general rule.

In relation to the Net Stable Funding Ratio, the CRD will only provide for reporting obligations, without any specific rates or requirements. In relation to the Liquidity Coverage Ratio, the Basel III definition will be applied, with a provision for review in 2015. During the observation period, banks will not be required to disclose their LCR ratios.

In relation to the regulation of systemically important financial institutions, the European Commission's position is that this should be addressed under the crisis resolution framework by strengthening supervision (with on-site inspections). The European Commission is not convinced that imposing an additional capital requirement is the right answer. The issue is still being debated at the international level.

¹ Here, aligning the Basel III and CRD 2 requirements may be a challenge.

In its letter to the European Commission on *CRD4*, the *EBIC*² *pointed out* that special emphasis should be given to specificities of the European banking sector and due account should be taken of developments in other jurisdictions in order to preserve the competitiveness of European banks. Regulators should consistently reduce the scope for shadow banking activities. The cumulative impact of all the various legislative measures currently on the table should be assessed.

The EBIC supports the creation of a harmonised Single Rule Book, with the proviso that it should allow for differentiation according to national and product specificities. The EBIC also supports the prohibition of "gold plating". The EBIC stresses that the European Commission should not re-open issues which have already been agreed upon in the CRD and its two previous reviews.

The **EBF Banking Supervision Committee set up a working group on the Single Rule Book**. (The European Banking Authority has the key role to play in developing the rule book). In relation to national options and discretions, the working group highlighted the following points:

- ↳ Special care should be taken when abolishing the national discretions for covered bonds, the same applies to amending the preferential weighting of mortgage exposures (35% for residential mortgages, 50% for commercial mortgages).
- ↳ Based on the principle of responsible lending, the working group advocates for the need to retain the mandatory LTV limit.
- ↳ The abolition of option 1 in the weighting of exposures to banks under the standardised approach (and under the partial use of the IRB approach) may have serious consequences.

In relation to CRD4, the EBF considers it imperative that in respect of liquidity, the regulation only provide for reporting obligations.

1.1.2 USA regulation

The U.S. regulatory and supervisory authorities are committed to implementing the previous Basel decisions (trading book, capital requirements for securities) and the Basel III framework. However, it is unclear yet, how the provisions of the Dodd-Frank Act prohibiting the use of external ratings will be applied. The authorities are exploring possible alternative solutions but they are not optimistic³. Changing the Dodd-Frank Act is unlikely under the current Congress. What is likely though is that its implementation may be delayed.

The extra-territorial application of the Fed rules (especially of those related to capital requirements) for systemically important financial institutions (SIFIs) will depend on the results of the relevant negotiations in process at the international level. The FDIC⁴ living will and orderly wind-down requirements for U.S. SIFIs may also affect foreign banks.

² The European Banking Industry Committee is a common platform of European associations representing the banking industry.

³ European banks are concerned that the U.S. may not implement the Basel framework. Hence, it has been raised that CRD4 or certain parts of it should only take effect if the Basel framework is implemented in the U.S.

⁴ Federal Deposit Insurance Corporation is the U.S. deposit insurance agency.

The U.S. Congress would relax the Volcker Rule, or even repeal some of its provisions⁵. The U.S. regulatory agencies are committed to implementing the FSB high-level principles for remuneration policies and consider that the U.S. is in compliance with those principles.

1.2 Liquidity - funding

1.2.1 EBA⁶ proposal for an additional liquidity monitoring tool

The EBA has the key role to play in the implementation of CRD4 during the observation and transitional period. Complementing the Basel III liquidity ratios, the EBA proposes the introduction of a Maturity Ladder Reporting Framework (MLR) to monitor banks' liquidity. The MLR would be applied by supervisors at good (non-stress) times at the individual and consolidated levels. The proposed reporting framework is aimed to serve as a basis for dialogue between managements and supervisory authorities to bridge net funding shortages. The proposed framework would take better account of banks' actual asset/liability management and take into consideration actual "behavioural" characteristics, in addition to the contractual terms and conditions. During the initial consultations, industry experts did not support the MLR, given that it would impose additional reporting requirements on banks. Submission of the MLR to public consultation will be decided on at a later stage. The EBA intends the MLR to be a mandatory technical standard and proposes its introduction at the global level by the Basel Committee.

1.2.2 IIF research: impact of financial sector regulatory reforms on banks' funding cost

This IIF study, published in March, analyses the impacts of tightened capital and liquidity regulations on banks' funding cost and on the economy as a whole. The main findings of the study are as follows:

- ↳ Understanding the impact of financial sector regulatory reforms on banks' funding cost is key to assessing the economic impact of these reforms.
- ↳ Tightened regulations may increase the costs of funding banks through the various funding channels.
- ↳ Decision makers and researchers say the increase in funding costs will be limited and have a moderate economic impact.
- ↳ The authors of the study are sceptical regarding this assessment: economic theory suggests that the supply curves of both bank debt and equity are upward sloping, particularly in the short-term.
- ↳ Current data show that the costs of debt and equity are relatively high.

All in all, the idea that banks may have cheaper access to the extra capital and liquidity required by the new regulations because investors would consider banks to be more secure than before seems unrealistic, as 1 \$ of equity investment in a bank would immediately be worth less than 1 \$ of asset of the bank.

1.2.3 Impact assessments related to liquidity

The CEBS in March published the results of a quantitative impact study conducted on liquidity. The study concludes that the banks involved would need EUR 1,800 billion in

⁵ See our 2nd Quarter 2009 report.

⁶ EBA: European Banking Authority

additional funding and EUR 1,000 in additional liquid assets to meet the Nest Stable Funding Rate (NSFR) and LCR standards, respectively.

The EBF Executive Committee decided to assess the impact of the proposed liquidity framework by involving a consultant firm rather than conducting the assessment internally. The results of the study will be published in June in an aggregate form, without presenting the deficiencies of the individual institutions or markets.

1.3 Capital rules for central clearing counterparty (CCP) exposures

Following its proposal for a regulation on the clearing of derivatives through central counterparties, the European Commission, simultaneously with the Basel Committee, published a consultation document on the capitalisation of bank exposures to central counterparties. The consultation paper proposes a preferential 2% risk weight for exposures to qualifying CCPs, while for non-qualifying CCPs, the general 8% risk weight would be applied.

The IBFed⁷ expressed two major concerns regarding the proposal:

- ↳ The capital framework currently contemplates no capital charges for such exposures. Imposing a capital charge for CCP exposures is a negative move and the recommended approach creates burdens that outweigh the supervisory benefits that might result from the capital charge. The distinction between qualifying CCPs and others also gives rise to concerns. Furthermore, the rationale and efficiency of addressing macro-systemic risks through micro-prudential supervision is questionable.
- ↳ The IBFed recommends taking into account the ongoing initiatives in the EU, the U.S. and other jurisdictions when qualifying CCPs in terms of risk and consequently in assessing the need for the capitalisation of bank exposures to CCPs.

In the EBF's opinion, any change should be put in the context of the general overhaul of the prudential requirements, considering also the interplay with the rest of the measures, notably those geared to stress the requirements of the market risk. Any new measure should be risk-sensitive and in proportion to the risks faced by banks. The interaction between the proposals regarding the capitalisation of bank exposures to CCPs and the large exposures regime is unclear.

1.4 Operational risk

The Basel Committee in December 2010 published two consultative documents on operational risk. Comments were invited by February 25, 2011.

1.4.1 Sound practices for the management and supervision of operational risk

This consultative document updates the Basel Committee's 2003 paper on this topic. The updated version highlights the evolution of operational risk management since 2003 and is

⁷ 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).

based on best industry practice and supervisory experience. The document outlines eleven principles of operational risk management, covering governance, risk management environment and the role of disclosure. It provides principles regarding the responsibility of the board of directors and the need for banks to develop, implement and maintain a framework for operational risk management that is fully integrated into the bank's overall risk management processes. In respect of governance, the proposal outlines the responsibilities of the board of directors and senior management. In respect of the risk management environment, the proposal provides principles for the identification and assessment, reporting and monitoring, control and mitigation of operational risks and business resilience and continuity. The principle regarding disclosure is that a bank's public disclosures should allow market participants to assess the bank's approach to operational risk management.

In its response to the consultative document, the IBFed drew attention to three points:

- ↳ Financial regulatory agencies should take into account the nature, size, complexity and risk profile of a bank when evaluating its implementation of the operational risk principles.
- ↳ The framework should not require the board of directors to take on roles that may detract and conflict with the board's strategic oversight responsibilities (board responsibilities should be strategic, not operational).
- ↳ The principles should be risk-based, not prescriptive.

1.4.2 Operational risk - Supervisory guidelines for the Advanced Measurement Approaches (AMA)

The consultative document on supervisory guidelines for the Advance Measurement Approaches points out that, over time, the operational risk discipline will mature and converge towards a narrower band of effective risk management and risk measurement practices. The paper seeks to identify supervisory guidelines associated with the development and maintenance of key internal governance, data and modelling frameworks underlying an AMA.

The IBFed provided several comments on the document, addressing the importance of independent validation and verification, the need to clearly distinguish between the responsibilities of the board of directors and senior management, items included in or excluded from the gross loss computation, pending losses, legal events, AMA models based on scenario analysis, grouped losses and the threshold level for single losses, recoveries, insurance mitigation and due process for the supervisory review and assessment of operational risk models.

1.4.3 EBF response to the consultation paper on guidelines on AMA changes (CP 45)

The EBF welcomed the CEBS/EBA's objective to provide a framework for AMA changes. The proposed categorisation scheme would encourage common understanding of the circumstances that should give way to an application with the competent authority. It would be useful if explicit recognition could be given to the case of takeovers. In other words, if a banking group takes over a subsidiary which had an AMA in place, duly approved by the competent authority, it should suffice for the group to communicate to the competent authority its intention to maintain the legacy AMA of the subsidiary. Regarding the time for the submission of the required documentation for changes, the EBF considers that six months prior to the planned implementation, in accordance with the relevant Article of the CRD,

providing that the competent authorities should reach a joint decision on application within six months.

1.5 EU framework for crisis management in the financial sector

Following its communication published in October⁸, the European Commission in January released a consultation paper on the technical details of a possible EU framework for bank recovery and resolution. The new framework aims to ensure that authorities have the powers and tools to resolve financial institution in crisis, without taxpayers bearing the burden. The ultimate goal is to ensure that banks can be resolved in a way that does not threaten financial stability, minimises the risks of contagion and ensures the continuity of essential financial services.

The proposals put to consultation were basically those put forward in the October communication:

- ↪ a requirement for institutions and authorities to prepare recovery and resolution plans;
- ↪ powers for supervisors for early intervention to prevent the problems from aggravating and to ensure recovery, including requiring the replacement of management, or requiring an institution to divest itself of activities or business lines that pose an excessive risk to its financial soundness;
- ↪ resolution tools, such as powers to transfer assets and liabilities of a failing bank to another institution or to a bridge bank;
- ↪ identifying resolution authorities to exercise the resolution powers (prevention, crisis management);
- ↪ the European Supervisory Authorities should be given a coordination and support role;
- ↪ establishment of national resolution funds funded by contributions from banks to cover the costs of resolution;
- ↪ use of debt write down/debt conversion (bail in) as a resolution tool;
- ↪ allowing certain derogations from the EU Company Directive.

The EBF updated its previous position on the proposal with some new aspects:

- ↪ The EBF supports the creation of a framework that minimises the systemic and fiscal consequences of bank failures and eliminates moral hazard.
- ↪ Resolution frameworks need to be introduced globally to ensure a level playing field.
- ↪ The Commission should be mindful of overlap with other regulatory initiatives and make policy choices both within the EU and globally.
- ↪ An EU crisis management framework should be straightforward, predictable and all encompassing.
- ↪ There needs to be legal certainty with regard to the accountability and liability of the institutions and authorities involved in crisis management.
- ↪ The link with macro-prudential supervision must be stressed.
- ↪ Enhanced supervision and prevention should be the key to avoid the use of the resolution tools. Many of the proposed supervisory powers referred to are already enshrined in the CRD and should be utilised.
- ↪ It is essential that the role of each authority involved in the process is clearly specified in their mandates to avoid gaps and overlaps.

⁸ See our 4th Quarter 2010 report.

- ↪ Prevention, early intervention and resolution measures must be clearly defined in terms of their respective tools and measures. These in turn must be used proportionally.
- ↪ Recovery and Resolution Plans or other preventative measures should not be used for supervisory intervention in the structure or operation of healthy financial institutions without restructuring or resolution having become necessary.
- ↪ The trigger mechanism should be as transparent, objective and predictable as possible.
- ↪ The corresponding resolution tools need to also be more clearly assigned within the timescales of these phases clearly differentiating between recovery and resolution objectives.
- ↪ Netting arrangements are an essential instrument for effective risk mitigation. A suspension of the close-out netting mechanism should therefore only be considered subject to an impact assessment. If implemented, a suspension of the netting mechanism should be subject to strict limitations.
- ↪ The need for resolution funds and the synergies with Deposit Guarantee Schemes (DGS) should be considered in the light of the whole framework and other supervisory reforms including the Deposit Guarantee Schemes Directive (DGSD) and the Capital Requirements Directive (CRD).
- ↪ The cost of a bank failure should be borne by shareholders and holders of other loss absorbing instruments. Creditors should bear losses only in exceptional circumstances.
- ↪ The framework should ensure equal treatment of creditors and shareholders across home and host member states and maintain financial stability in all member states concerned.
- ↪ Debt-write down (bail-in) mechanisms must be further analysed and a thorough impact analysis must be done before they are introduced.
- ↪ Bail-in mechanisms would be a last resort action once other tools have failed and only in situations which are transparent and leave the holders of the bailed-in instruments in no worse a position than had the bank been liquidated
- ↪ Shareholders should bear losses before junior creditors and this in turn before senior creditors.

There is no clear preference among EBF members as to whether the comprehensive or targeted approach to bail-in would be more appropriate. The comprehensive approach would be a flexible tool for the resolution authorities; the authorities should have the role to decide the scope of debt to be converted into equity, based on the institution's capital needs. (This approach would imply uncertainty for investors, as they would not understand clearly what types of risk they incur). Under the targeted approach, the scope of debt to be converted into equity would be specified in a contract. (This approach would be safe for investors, but may not ensure the resolution funding needed.)

1.6 Revision of the Investor Compensation Schemes Directive (ICSD)

The European Parliament's rapporteur in January presented his proposals regarding the revision of the Investor Compensation Schemes Directive. The rapporteur identified the following key goals:

- ↪ increased protection of consumers through raising the coverage level,
- ↪ creating a single European financial services market through harmonising investor compensation schemes,
- ↪ laying down the principles for the long-term funding of investor compensation schemes.

The rapporteur does not support the extension of the investor compensation schemes to UCITS⁹, this should be addressed under a revision to the UCTS Directive. He proposes to raise the level of coverage from the current EUR 20,000 to EUR 100,000 (instead of the EUR 50,000 proposed by the Commission). However, higher levels of coverage currently in place in the various member states could be maintained. The rapporteur supports the ex ante funding of the schemes under a harmonised system, but he considers the target fund level of 0.5% of the assets covered to be too high. As for the borrowing mechanism between national schemes, the rapporteur would support 5% of the pre-fund to be made available for lending to other schemes instead of the 10% proposed by the Commission, and only after the funds have been filled up.

The EBF disagrees to raising the coverage level and considers that there is no need for full harmonisation of the coverage level. The EBF is also opposed to the extension of the protection to UCITS. It also expresses reservations regarding the proposed borrowing mechanism between national schemes, the transition period provided for filling up the ex ante funds and the lack of clarity on the rules for making contributions to the funds. In the EBF's opinion, the target fund level should be set at 0.1% of the assets covered.

1.7 EU-wide stress test - Scenarios and methodology

The EBA in March published the scenarios and methodology for its 2011 EU-wide stress test. The banks involved in the test cover over 60% of total EU banking assets. The EU-wide stress test is a supervisory tool designed to assess the resilience of European banks to external shocks. The scenarios are designed by the ECB. In the adverse scenario, GDP falls by 4 percentage points (one percentage point more than in the 2010 exercise). The test will include country-specific stress (such as property prices, interest rates, sovereign risk). The capital threshold will be focused on the adequacy of Core Tier 1 capital. The EBA is currently defining common criteria for Core Tier 1 capital to be applied consistently across the EU. The exercise is being run between March and June 2011 on banks' balance sheets as of end 2010. Results of the exercise will be published on a bank-by-bank basis in mid June. The EBA is coordinating the stress test with the national supervisory authorities, the ESRB, the European Central Bank (ECB) and the European Commission.

2. Other EBF and IBFed activities related to banking regulation

2.1 European banking sector position on barriers to regulatory reform – Letters to EU Commissioners

Following the publication of the final version of the Basel III capital framework, the EBF wrote a letter to the EU Commissioners for Internal Market and Economic and Monetary Affairs, once again drawing attention to negative impacts on the EU banking industry of the proposed regulatory reforms. (In Europe, banks provide 75% of total financing. This ratio is below 25% in other jurisdictions). In its letter, the EBF addresses three issues related to the European banking sector's competitiveness:

- ↳ Proposed regulatory changes (including the proposed revision of the Deposit Guarantee Schemes Directive, the proposed legislation on bank resolution funds and the proposed imposition of a bank tax).

⁹ Undertakings for Collective Investment in Transferable Securities

- ↳ The capacity of the European capital markets (the question whether the European capital markets will be capable of meeting banks' extra capital needs ensuing from the proposed regulatory changes).
- ↳ Banks' profitability amidst competition for capital with other sectors of the economy.

The EBF stresses that an appropriate balance should be struck between increasing the safety of banks and their need to adapt to the new regulatory requirements in order to prevent their dropping out of the market. The EBF continues to support regulatory reforms aimed at strengthening the safety, supervision of and risk management in the banking system and adopting an effective bank resolution framework. However, it has concerns regarding the new prudential requirements, which are burdensome and adversely affect banks' competitiveness, especially in Europe. Introducing the reform globally, based on experiences of Basel II, is key. Accordingly, it is essential that the European Commission make the introduction of the new regulations subject to their implementation on a global basis.

The EBF also addressed in detail the potential impacts of the regulatory reform on trade finance (export credits) and on global trade and the global economy as a whole.

Meanwhile, the Basel Committee made it clear that it was fully aware of the problems related to the regulations on liquidity and leverage ratio and of the importance of ensuring a level playing field and consistent implementation of the new regulations on a global basis. At the same time, the Basel Committee rejects any attempt to change the already adopted decisions. The Committee says the focus now should be on implementation of the new regulations.

2.2 EBF position on systemic risk

In the wake of the financial crisis, the EBF in the past period has given special attention to understanding the nature of and possible ways to address systemic risk. In the EBF's opinion, systemic risk is a complex and global problem. Addressing it will require changes in the global financial architecture.

Every market participant contributes to systemic risk. Therefore, further analysis is imperative before introducing regulations based on institution size; the sources and processes of systemic risk should be identified. The use of lists of Systemically Important Financial Institutions (SIFI) is not the right solution to address the root problems. Systemic risk is dynamic in nature. Therefore, it should be monitored through dynamic monitoring mechanisms.

Political decision makers should coordinate their initiatives to tackle systemic risks with consistent global standards. In the EBF's opinion, capital surcharge should not be considered as an option. Defence against financial instability requires an efficient crisis management framework, including early intervention mechanisms and resolution regimes.

Systemic risk prevention is not only a matter of individual banks surveillance. The quality of supervision of each jurisdiction separately and the effectiveness of the EU wide framework should also be part of the assessment.

Ensuring a level playing field is an important ingredient of financial stability. Measures aimed to counter systemic risk should ensure a level playing field across the EU and globally.

EBF stands ready to collaborate with policy makers with a view to defining a well-balanced framework that:

- ↪ takes account of the true sources of systemic risk;
- ↪ allows for a continuous update and is forward-looking by nature;
- ↪ allows for effective actions to reduce the risk of contagion, giving supervisors clear and consistent mandates in all jurisdictions;
- ↪ allocates prudential requirements commensurate with the systemic risk involved, without imposing additional capital surcharges.

2.3 ESMA¹⁰ consultation on the application of the endorsement regime for credit rating agencies

The European Securities and Markets Authority (ESMA) in January issued a call for evidence asking for market participants' views on the endorsement regime for credit rating agencies. In March, the ESMA launched a public consultation on the issue.

During the consultation, the EBF repeatedly expressed its disagreement with the European Commission's and the ESMA's interpretation of the endorsement regime. The EBF believes that the endorsement process was created as a deliberately flexible mechanism, to allow for the continued use of all ratings issued by the largest credit rating agencies, irrespective of the country of issue of the rating or of the analyst's location. The EBF also raised concerns about the potential economic effects of an interpretation that would lead to the de-recognition of ratings issued in non-EU and non-equivalent jurisdictions.

The European Parliament's own initiative report¹¹ agrees with the EBF's interpretation.

2.4 EBF response to the CEBS¹² Consultation Paper on the Guidebook on Internal Governance (CP 44)

In its response to this consultation paper, the EBF welcomes that the paper states that the principle of proportionality applies to all guidelines. As the national provisions vary a lot, the corporate governance provisions should be adequately flexible and formulated as comply-or-explain principles. In relation to groups, the local authorities/supervisors should take into account the increased liability of the management body of a parent company regarding the group's structure, reporting lines and internal control. Regarding the term "management body", it is important to clarify whether, in respect of the issue in question, it refers to the board of directors in its supervisory function or the executive management.

2.5 Leasing – Meeting with the European Commission

A joint delegation of the EBF and Leaseurope met with competent officers of the European Commission. During the meeting, it turned out that the EC representatives were unaware of the adverse affects the proposed changes in leasing accounting rules would have on banks' capital requirements. The Commission's representatives said the relevant standard was still under revision and it was unclear whether the IASB would be able to complete the standard by the June deadline. Therefore, they considered that banks' concerns regarding the contents

¹⁰ ESMA: European Securities and Markets Authority

¹¹ See our 4th Quarter 2010 report.

¹² Committee of European Banking Supervisors, the legal predecessor of the European Banking Authority.

of the proposed standard were premature. The EBF will not take further steps on the issue for the time being. However, member associations may, through their national supervisory authorities, try to influence the EBA's relevant work.

2.6 Reporting requirements

The EBF is organising a roundtable on proposed changes in banks' reporting requirements, to be held after consultations with the competent authorities. The roundtable will be attended by representatives from the EBA, the ECB, the ESRB and the European Commission and high-ranking representatives from the industry. During the roundtable, the EBF would like to review the following issues:

- ↪ An integrated approach to reporting requirements, covering all reports. The objective is to avoid that the national implementation of the new reporting requirements results in banks having to file reports under different criteria, definitions and categories, with different levels of detail, different frequencies and deadlines and in different technical formats with the different authorities.
- ↪ Raising awareness that banks' IT systems are accounting-driven and hence, the IFRS should be used as the common basis for reporting.
- ↪ Transparency of the reasons for requiring individual reports.
- ↪ Level of application (individual or group level).
- ↪ Requirements for the collection of historical data.

In the context of implementation of the new regulations and reporting requirements, the issue of a partial switch to the XBRL reporting format may be raised again.

3. EBF Payments Systems Committee

At its meeting, the Payments Systems Committee reviewed issues related to the proposed EU regulation setting an end date for migration to the main SEPA payment schemes (SEPA credit transfers and SEPA direct debits). The proposal to ban interchange fees for SEPA direct debits prompted objections: interchange fees are common practice and an important revenue item for banks in many member states. Migration to a new payment model may involve substantial costs. The European Commission has also promised to prohibit interchange fees for card payments. As the issue of interchanges fees for card payments affects all member states, the current dispute is far more than a banking technique issue. The Committee reviewed the arguments and lobbying techniques to be used in the debate with the EU authorities. Instead of the, mostly unsuccessful, economic arguments offered thus far, it was proposed that legal arguments should be brought to the forefront. In view of the importance of the issue, participants emphasised the need to use all possible forums (including convincing the Hungarian presidency). The objective is that the EU authorities recognise the financial intermediary system as an important infrastructure supporting economic growth and that the sector's development and profitability are not hindered by artificial competition law considerations.

The meeting also addressed the issue of bank's participation in the EU-level debate on electronic invoicing and how banks should relate to e-payment service providers (such as PayPal) in terms of competition law.

With Hungary holding the EU presidency, the Payments Systems Committee's next meeting will be hosted by the Hungarian Banking Association in Budapest.