



REPORT

**on Activities of the Hungarian Banking Association
1st Quarter 2013**

Budapest, May 2013

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1. Executive Summary – Economic environment and the Hungarian banking sector

The banking sector's operating environment remained basically unchanged in the first quarter of the year, with no economic growth in the EU's largest markets. Problems in the euro-zone continued, exacerbated by the crisis in Cyprus, and, although of less economic weight, the crisis in Slovenia is not a positive development, either. Based on the trends in the first quarter, the IMF has lowered its 2013 global growth forecast to 3.3%. Growth is projected at 1.2% in the advanced economies and 5.3% in the developing economies.

There was no positive change in the conditions affecting banks' operations in Hungary, either. Apart from some positive macroeconomic data, such as a favourable inflation rate, a general government deficit below 2 percent and government debt falling to 79%. The MNB continued its rate cut cycle in the first quarter. However, these moves had no stimulating effect on the economy. At the same time, as an adverse development for banks, due to external effects, the HUF exchange rate remained weak. The HUF/EUR average exchange rate was 293 in the first two months of the year and around 300 in March.

The loan-to-deposit ratio had fallen from 140% in 2010 and 130% in 2011 to 110% by the end of 2012. Domestic savings have become increasingly important, however, the stock of deposits has not increased. Government bonds with favourable yields have become more accessible and advertised for retail investors, posing a competition to banks' deposit taking opportunities.

The banking sector posted an aggregate loss of HUF 161 billion in 2012, with the economy showing no signs of growth. Creditworthy demand remained low and banks' continued to apply stringent credit appraisal policies.

While the share of foreign currency loans grew in corporate lending, that of HUF loans continued to shrink. Corporate lending rates fell: for example, the interest rate on five-year loans dropped to 9.1%, a 14-month low. This may have a positive effect later during the year.

As an important development in municipal lending, after the debt consolidation of municipalities with less than 5,000 inhabitants at the end of 2012 through a one-time non-refundable state aid, the consolidation of municipalities with more than 5,000 inhabitants has come onto the agenda. The Association submitted a proposal for the Ministry for National Economy for the implementation of the consolidation.

In the meantime an amendment to the 2013 Act on the Central Budget was passed. This provides that the state may carry out the assumption of certain debts by providing a one-time subsidy for debt elements with a value under HUF 250 million. This measure would ensure the involvement of smaller creditor banks and most savings cooperatives in the debt consolidation.

In retail lending, no significant changes were seen in Q1. Demand is low and banks' credit appraisal criteria continue to be tight.

In the meantime an amendment to the 2013 Act on the Central Budget was passed. This provides that the state may carry out the assumption of certain debts by providing a one-time subsidy for debt elements with a value under HUF 250 million. This measure would ensure the involvement of smaller creditor banks and most savings cooperatives in the debt consolidation.

Based on the relevant legislation and practice, an eviction and auctioning moratorium was put in effect again during the winter, slowing mortgage lending, anyway.

In response to the governments proposals, in February the Association coordinated a campaign aimed at publicising the Exchange Rate Cap Scheme. As a result of this campaign, the number of those using the scheme has now exceeded one-third of those eligible, with 132,000 overflow accounts opened. As another important development, at the initiative of the government, Parliament has extended the application deadline for the Scheme to the end of May 2013.

The review of regulatory proposals on home subsidies was a priority task in the first quarter. Our proposals were duly taken into account in the final legislation.

The first effects of the imposition of the financial transaction levy were felt in the first quarter. Banks duly applied the levy as provided by law. As expected, most banks transferred the levy to the customers. Notwithstanding, according to the Economy Ministry's estimates, the revenues from the levy will be HUF 80 billion less than planned.

A major development in the first quarter was the MNB proposal for the outsourcing of cash processing. According to this, cash processing, which is currently considered as an ancillary financial service subject to central bank licensing should be re-classified as an outsourced banking activity. The Association expressed its strong opposition to the proposal.

At the end of the last year, the MNB and the Competition Authority drafted a proposal for the regulation of interbank interchange fees. We drew attention that a further substantial reduction in interchange fees would entail serious risks. For example, due to the changed fee structure, purchase transactions, which are currently free of charge for the consumers/card holders, would most likely be subject to a fee and/or annual bank card fees would need to be increased significantly.

In line with similar activities at the EBA and national supervisors, PSZÁF and the MNB have been actively working on reforming the BUBOR rate-setting process since the autumn of 2012. The current decision is that until the adoption of an EU legislation, the issue shall be regulated by a PSZÁF Recommendation. Accordingly, PSZÁF published for consultation a draft recommendation for the BUBOR rate-setting process. Comments were invited by the middle of March. In our comments, we pointed out that the rate-setting process should be addressed as part of a wider reform of the BUBOR process.

The Irish presidency addressed the trilogue on capital requirements and liquidity management as a key priority and it sought to conclude it in the first quarter of 2013. This was achieved, with member states coming to agreement on the CRR and CRD4. The European Parliament passed the CRR/CRD4 on April 16. Accordingly, this important piece of legislation, determining the operating conditions of European banks will by all probabilities enter into force on January 1, 2014.

The discussions on the banking union continued in the first quarter. Following the agreement in the European Parliament's Economic and Monetary Committee (ECON) and the Council of Finance Ministers (ECOFIN), the trilogue on the proposed Single Supervisory Mechanism (SSM) commenced before Christmas. According to information received in the middle of March, the trilogue was focused on issues related to the division of work between the ECB and national supervisors, close cooperation by the ECB with non-euro-zone member states, appointment of the Chair and Deputy Chair of the Supervisory Board and the rotation of the Steering Committee. Key issues related to the EBA Regulation included voting, the frequency of stress tests, the EBA's role in colleges of supervisors and the legal status of the single supervisory manual. The ECOFIN is expected to vote on the SSM in April or on May 14, the EP vote is scheduled for May 21.

The Association held its Annual General Meeting on March 22. The General Meeting amended and updated the Association's Rules and elected a new president and two board members to fill the vacancies on the Board. Also, the General Meeting elected arbitrators to the Permanent Court of Arbitration of Money and Capital Markets.

2. Major developments affecting banks' operations

2.1. Retail lending

Extension of the application deadline for the Exchange Rate Cap Scheme

Despite extensive efforts by banks, less than one-third of those eligible had availed themselves of the Scheme by the original deadline of end-2012. Since creditor banks have considered the Scheme as a good product that can help customers, the Association supported that the government and Parliament extend the application deadline for the Scheme to the end of May 2013. Since February, the government and the Association have conducted a joint campaign to publicise the Scheme. As a result, the number of those using the scheme has now exceeded one-third of those eligible, but is still low. (According to PSZÁF data, until the end of February, debtors opened more than 132,000 overflow accounts, thus significantly reducing their monthly repayment burdens and relieving themselves of a HUF 7 billion in interest payments).

Review of proposed decrees on home subsidies

At the request of the government, the Association provided comments on proposed amendments to the decrees on home subsidies. Banks supported the government's objectives to increase the non-refundable socio-political subsidy for new homes and the "half socio-political subsidy" for used homes and the enlargement of existing homes.

We provided technical comments aimed at promoting implementation of the decrees:

- We objected to the proposal that would require banks to determine the customers' eligibility for the subsidy based on medical documents (for example, on permanent disability or pregnancy). Instead, we proposed that banks should decide based on certificates issued by the competent authority.
- We indicated that in certain family law issues (for example, common law marriage) the proposed regulation is deficient.
- We requested the legislators to clarify the engineering - construction technology - control tasks to be delegated to the banks.

According to our information, most of our proposals have been taken into account. However, due to government considerations, the proposed decrees have been postponed.

New working group to address the issue of litigations for establishing the voidness of foreign currency-denominated loan contracts

Based on the February decision of the Board, The Association set up a working group from legal and business specialists from member banks to review experience regarding consumer lawsuits. Recently, a number of lawsuits have been filed by debtors and organisations representing debtors for

- a) declaring certain contractual provisions allowing the unilateral amendment of the loan contract (the increasing of interest and fees) null and void,
- b) declaring FX-denominated mortgage loan contracts or certain provisions of these contracts null and void,
- c) declaring certain interest and fee increases unfounded.

Most decisions adopted by the courts and the Financial Reconciliation Board have been favourable for banks and professionally well-founded and thorough. Based on these decisions and a set of key arguments we have developed, we proposed that banks should develop and represent a common

position on certain issues, in particular those related to FX lending, in litigations, customer communications and the press.

2.2. Corporate lending

While corporate lending started to pick up in the CEE countries in 2012, Hungary is the only country which has not been able to break the negative trend seen since 2008. Although, after four months without growth, corporate lending saw some increase in January 2013 (by HUF 13.6 billion), with the stock of foreign currency loans rising for the first time in 14 months, by a total of HUF 72.3 billion, lending in HUF shows a more grim picture, with a decline of HUF 68.5 billion in December 2012 followed by a drop of HUF 58.6 billion in January 2013.

The reason for the decrease in corporate lending is the weak economic outlook, the low appetite for investment and the low level of foreign direct investment, and difficulties faced by certain sectors (the real estate sector, municipalities). All this reduces banks' lending appetite, while the interest of both banks and companies would be to increase capital placements. Adding to this is the drop in risk tolerance seen since the beginning of the crisis. Due to the uncertain environment, no significant improvement is expected anytime soon, perhaps the rate of decline may slow (to around 4 to 5 percent p.a.).

A positive development is that the effects of the central bank's interest rate cuts are increasingly felt in the pricing of corporate loans: the average interest rate on loans with a maturity of at least five years had melted down to 9.10 percent by January, a 14-month low. Also as a positive trend, the ratio of non-performing corporate loans fell from 18.3% to 17.2% in the last quarter of 2012. The balance sheet adjustment of banks continued: the loan-to-deposit ratio was at 118.9% at the end of 2012 - the level it was in June 2004. Liquidity in the sector is showing an improving trend as a result of this decrease in the loan-to-deposit ratio.

2.3. Municipal debt consolidation

In 2012, the government recast the laws regulating the day-to-day operations of municipalities and the provisions ensuring the performance of their functions and the framework for their financing was also changed. As a first step, the government sought to consolidate municipal debts related to day-to-day operations and development projects previously not funded by the state.

To achieve this, based on Act CLXXXVII of 2012, the state provided a one-time non-refundable aid to municipalities with less than 5,000 inhabitants and the multi-purpose micro-regional associations of these municipalities, as a repayment support for their debts to financial institutions.

As a second step, in relation to the debt consolidation of municipalities with more than 5,000 inhabitants, banks, by making special efforts, duly met their data provision obligation by the statutory deadline of January 11, 2013. Since then, the Association has submitted its proposal for the implementation of the consolidation. In developing the main principles, which are also supported by the various associations of municipalities, we focused on following the principles for the assumption by the state of foreign currency exposures.

In the meantime an amendment to the 2013 Act on the Central Budget was passed. This provides that the state may carry out the assumption of certain debts by providing a one-time subsidy for debt elements with a value under HUF 250 million. This measure would ensure the involvement of smaller creditor banks and most savings cooperatives in the debt consolidation.

2.4. Taxation issues

Developments related to the financial transaction levy

The Act on Financial Transaction Levy, taking effect on January 1, 2013, entailed a number of implementation issues. These were reviewed at our working group meetings. In relation to the issue causing the biggest uncertainty, the interpretation of the definition of repayment in relation to overdraft and bank card loans, we requested a ruling from the Ministry for National Economy. We received a satisfactory response: the Ministry agreed with our position.

We managed to obtain favourable results in relation to the tax return form for the levy. The most critical items from implementation points of view were omitted. Accordingly, the transactions will not have to be broken down by currency (FX, HUF) and items/transactions not subject to the levy will not have to be reported. Another major simplification is that the authority has dropped the requirement to report a multitude of informative data. The authority acknowledged that the short time allowed for implementation, and in many cases, the absence of a relevant legislation have not made it possible to set up the detailed data structure that was initially set out. At the consultation held between the Association and the Tax Authority, it was made clear that Tax Authority considers the agreed and issued form as an initial state and the banking sector should anticipate increasing reporting requirements in relation to the financial transaction levy going forward. The levy collected in the first months of the year falls behind the amount expected by the government. This strengthens the likelihood of potential changes to the legislation and the broadening of the scope of data to be reported in the tax returns. The Association maintains its position that, as agreed, the government should await the results of the first half of the year and then review the legislation.

Other taxation issues

In addition to the financial transaction levy, several other issues were also addressed during the meetings held on taxation issues in the first quarter. The need to amend the taxation rules for forgiven debts was raised several times. We communicated this issue to the Ministry for National Economy. We made proposals for relevant amendments to the personal income tax and stamp duty laws, requesting a more helpful regulation for the forgiveness of HUF debts and interest rate reductions, as is the case with foreign currency denominated debts. In order to solve uncertainties caused by ambiguities in the text of the legislation and to avoid any ensuing misinterpretations, we also checked with the Ministry the case when the income declaration required for a preferential treatment for tax purposes subsequently turns out to be wrong, including the related potential adverse consequences to the payer. At the working group's meeting, it was raised again that the 2009 basis for the bank tax was obsolete and should be adjusted. Also, we submitted a proposal for a more precise definition in the legislation, to make the bank tax refund for incremental SME lending more practicable.

A major achievement in relation to the long-debated issue of VAT on bank card services was that the Ministry for National Economy confirmed the industry's position that card scheme services are complex services and are considered as financial services, and accordingly, under the harmonised EU VAT law, are exempt from VAT.

3. Payments

3.1. Cash payments

Central bank proposal to outsource cash processing

The MNB has proposed to the Ministry for National Economy to draft a proposal for amendments to the provisions of the Banking Act related to cash processing. According to the MNB, cash processing,

which is currently considered as an ancillary financial service subject to central bank licensing should be re-classified as an outsourced banking activity. In the central bank's opinion, this activity is a core banking service, currently performed by external market players, hence the regulation should be adjusted to the reality.

The Ministry for National Economy held a meeting with the MNB and the Association on the issue. At the meeting as well as in our subsequent written comments sent to the participants we expressed our strong opposition to the proposal:

- The current smooth operation of the cash processing market is ensured by the fact that the responsibility for entry or exclusion from the market rests with an organisation with the powers of an authority (the MNB),
- The few – and financially strong - cash processing companies present in the market represent a strong market power vis-à-vis banks, consequently, banks would not be able to enforce their interests in a potential outsourcing contract (while the responsibility for the activity would remain with them).
- Pursuant to the central bank's proposal, anyone would be able to enter this safe market, without any permit required: for example, a bank would not be in a position to refuse if a major customer (for example, a nationwide chain store) recommended to it a new cash processing company.
- There is no EU law to stipulate that cash processing is a core banking activity and the relevant legislation on outsourcing primarily relates to data processing.

We have no knowledge of the Ministry proposing any amendment to the Banking Act since our February letter.

3.2. Statistics on basic payment accounts and bank account switching

At its March 2012 meeting, the Board issued its Recommendation No. 1/2012 on basic retail payment accounts. The Recommendation has been adopted by 17 banks and savings cooperatives, who have specified their account products classified as basic payment accounts.

The Recommendation took effect on April 2012. According to figures received from banks, 21,250 basic payment accounts have been opened since then, including 664 by non-Hungarian EU citizens. Since this self-regulation was adopted at the request of the Ministry for National Economy, we informed the Ministry on these statistics.

In relation to the Association's self-regulation on simplified bank account switching (Recommendation No. 6/2009), Customers initiated bank account switching in 4,167 cases, out of which 2,219 cases were successfully concluded in 2012.

Although both self-regulations were adopted in response to the relevant EU initiatives, the European Commission is not satisfied with banks' activities in these areas. Therefore, new regulatory proposals are expected at the EU level on both issues. We should strive to ensure the least possible deviation of the proposed EU regulations from the principles of the already existing self-regulations.

3.3. Access by third party service providers to payment account information

The European Banking Federation requested its members to comment on the European Central Bank's recommendations for payment account access services. Services aimed to make online shopping easier in the space between the customer, the customer's bank and the merchant are common practice in internet banking. These services can be split into two parts: provision of information to the customer on his account details and participation in the execution of the payment instruction.

While these services can significantly improve customer service, they may imply considerable security risks. The ECB recommendation is aimed to mitigate these risks.

The Association gave comments on the ECB Recommendation based on oral and written consultations within the Payments Working Group. Overall, we supported the proposal to regulate these services. However, since these services have become part of day-to-day life, we expressed our opinion that the ECB Recommendation would not be an appropriate regulatory tool

- without a clear definition of its substance,
- without defining the place of these services in the system of payments services, and
- without a clear allocation of liabilities.

We urged for the problem to be addressed by superior legislation (an EU Directive or national legislation).

3.4. Electronic Payments and Clearing System (EFER)

Consultations on the possibilities and conditions for the involvement of banks and GIRO in the government's Electronic and Payments System project continued in the first quarter. (A main objective in the EFER project is to radically reduce the number of credit transfers made to wrong account numbers in payments to government agencies, by putting in place a home banking system). As a first step, we organised a meeting for the software developers with GIRO's management to assess the benefits of GIRO's participation in the project. This was followed by a meeting involving all parties (the government body responsible for the project, the project management, the Hungarian State Treasury and GIRO). At the meeting, it was clarified that there were several alternatives for GIRO to be involved in the project, but it was also a realistic option that the government might develop a direct connection with the individual banks. We also had a meeting with the Deputy State Secretary of the Ministry for National Development, where we indicated that, whether the system was going to be developed through GIRO or directly with the banks, banks should be furnished with the specification of the system in due course to enable them to provide for the necessary development resources in time. At the time of writing this report, the testing of the system is underway with the involvement of one or two banks. Project management has indicated that, after successful testing, they will count on the Association's assistance in involving the rest of the banks in the project.

3.5. Bank cards

Proposed regulation on interbank interchange fees

At the end of 2012, the MNB and the Competition Authority drafted a joint proposal for the Ministry for National Economy for the regulation of interbank interchange fees.

The various actors (regulators, authorities, market players) have taken different positions on this essentially technical issue. The Association and its members fully agree that promoting the use of cashless payment instruments is an important task and a common economic interest. However, this should be achieved through well-prepared and well-founded measures and tools.

The regulatory proposal is based on the assumption that lower IC fees on domestic transactions will result in the widening of the acceptance network, with more merchants entering into contracts with card acceptance service providers and thus, more POS terminals established, and all this will promote card payments and contribute to curbing the shadow economy.

We feel it our professional duty to draw attention to the fact that a further substantial reduction in interchange fees would entail the following risks:

1. Due to the changed fee structure, purchase transactions, which are currently free of charge for the consumers/card holders, would most likely be subject to a fee and/or annual bank card fees would need to be increased significantly.

2. Bank card development and innovation projects would diminish. This would put Hungary's international competitiveness at risk.
3. With the slowdown in the adoption of new technologies, the Hungarian bank card market's exposure to fraud would increase significantly.
4. Based (also) on international data, we assume that the reduction of interchange fees would not result in the widening of the card acceptance network, but may have a contrary effect.

We drew attention that any regulatory measure can only be well-founded if preceded by wide consultations involving specialists from the implementing card associations and banks, in addition to the regulatory and supervisory authorities. Furthermore, the expected market impacts of the proposed regulation should be assessed through calculations and detailed impact analyses.

The European Commission's regulatory proposal for interchange fees is expected to be published in the second quarter. The proposal is yet unknown.

In the light of the above arguments, we proposed the postponement of the proposed regulation and the conducting of more discussions between the government and market players to avoid any measure that would harm the development of the bank card market.

4. Hungarian Financial Supervisory Authority (PSZÁF)

4.1. Consultation on proposed PSZÁF recommendations: remuneration reporting, BUBOR

In line with similar activities at the EBA and national supervisors, PSZÁF and the MNB have been actively working on reforming the BUBOR rate-setting process since the autumn of 2012.

The supervisory authority has conducted targeted inspections at 17 affected banks on the issue and committed significant resources to analysing the relevant data for the period between 2004 and 2014, to establish whether there had been any manipulation around the BUBOR. The Authority has established that although there have been some shortcomings in the rate-setting process, there are no signs of any manipulation. The MNB drafted a set of proposals in January. The issue was reviewed at the February meeting of the Financial Stability Council.

In the middle of February, PSZÁF issued a press release on the issue and published for consultation a draft recommendation for the BUBOR rate-setting process. In our comments on the proposal we pointed out that the rate-setting process should be addressed as part of a wider reform of the BUBOR process. We proposed a consultation for the parties involved to clarify those issues not addressed by the recommendation and requested that the final recommendation only be issued afterwards.

In accordance with our proposal, at PSZÁF's initiative, consultations between the four parties involved (MNB, PSZÁF, Hungarian Forex Association, Hungarian Banking Association) commenced in March.

4.2. Reporting: new PSZÁF decrees

In the first quarter, we reviewed and provided comments on the following proposed supervisory decrees:

1. Decree on the form and content requirements for notifications related to investment funds;

2. Decree on detailed rules for the form and contents of communications in procedures subject to mandatory electronic communications related to investment funds;
3. Decree on detailed rules for the form and contents of communications in procedures subject to mandatory electronic communications related to venture capital funds, issuers and non-natural persons submitting public bids and for the form and contents of submissions to be submitted by natural persons for the approval of the bid in procedures initiated by natural persons submitting public bids.
4. Decree on detailed rules for the form and contents of communications in procedures subject to mandatory electronic communications between issuers of publicly offered securities and PSZÁF;
5. Decree on the form and content requirements for certain notifications required under the Capital Markets Act, not subject to mandatory electronic communications;
6. Decree on financial institutions' master data reporting obligations;
7. Decree on the rules for reporting major IT problems encountered during reporting.
8. Decree on the structure and contents of the separate auditor's report to be filed annually with PSZÁF (the draft decree is under trilateral discussion by PSZÁF, The Hungarian Chamber of Auditors and the Hungarian Banking Association).

4.3. Review of the proposed PSZÁF Recommendation on debt collection, consultations with PSZÁF, adaptation issues

PSZÁF held a consultation for banks on its Recommendation No. 14/2012. (XII 13) on consumer protection principles for debt collection, which should be implemented from May. There have been ongoing consultations on the Recommendation with specialists from member banks since the beginning of the year.

5. Regulatory changes, authority measures

We made comments and proposals for regulatory amendments/measures regarding the following issues:

- At the request of the Ombudsman for Fundamental Rights, we submitted a detailed report on experience of the implementation of the Act on Judicial Distraint. (We made proposals for amendments to the Act. Also, we proposed the introduction of a free choice of bailiff and customer-friendly procedures and the general reduction of bailiff fees).
- In relation to the proposed amendment to the Justice Ministry Decree on bailiff fees, we proposed that the fees for procedures related to the National Asset Management Company scheme should be reduced
- We submitted proposals for amendments to the Bankruptcy Act in relation to the bankruptcy and liquidation proceedings for strategically important companies. In connection with MP motion No. T/10507, we wrote a letter to the Minister.
- We held a meeting on tasks ensuing from the Supreme Court's Civil Law College's Opinion No. 2/2011 on unilateral contract amendments.

- We conducted correspondence regarding activities of the Financial Ombudsman,
- We reviewed and provided comments on the proposed revision to EU Regulation 1346/2000/EC on cross-border insolvency proceedings.

Electronic interface for authority inquiries, electronic communications with the Tax Authority (EBT)

In the context of this project, launched in the second half of 2012, we conducted consultations with the authorities and chambers involved. The consultations were concluded in February. During the consultations it became clear that without coordination by the competent Ministries of the various plans and development processes, the objective for the various authorities and chambers to apply a harmonised system in their communications with the banking sector cannot be achieved. In the middle of March, we approached the Deputy State Secretaries responsible for e-Administration at the Ministries involved (Ministry for National Economy, Ministry of Interior, Ministry of Administration and Justice) and those organisations where the system has been completed or is under development (the Tax Authority, the Hungarian Chamber of Commerce and Industry). In October 2012, the Tax Authority informed that contrary to its previous promise to implement a system similar to that used by the Hungarian Chamber of Commerce and Industry for electronic inquiries on information that falls under banking secrecy laws, it would send these inquiries through a communication channel it has established with a limited circle of banks. Shortly after this information, the Act on the Rules of Taxation was amended, requiring financial service providers to create the conditions, by July 31, 2013, for the use of electronic channels in their communications with the Tax Authority if the inquiry from the Tax Authority is received through an electronic channel. The Tax Authority issued the required system specifications as late as in February and March, therefore, the implementation time provided by the legislation is too short for banks to put reliable and tested systems in place. We reported this problem through several forums to various levels of the Tax Authority's management, but our request for extension of the deadline was not accepted.

MNB initiative for the voluntary limitation of FX swap exposures

The MNB proposed that banks should voluntarily regulate their FX swap exposure limits. Even after several consultations with the central bank and multiple amendments to the sample declaration proposed by the banks, the banking community remained divided on the issue. At its meeting of February 12, 2013, the MNB Monetary Council decided to withdraw the proposal. At the same time, the MNB reiterated that it continues to consider the sector's aggregate FX swap exposure as high and will continue to monitor it and if necessary, use the regulatory instruments available to it.

Amendments to the Anti-Money Laundering legislation

MONEYVAL, an international body monitoring AML measures, conducted an assessment in Hungary a few years ago. In its report it found some minor deficiencies in the AML legislation. The government submitted a proposal to the Parliament to eliminate these deficiencies. Beyond this objective, there was a crucial point in the proposal: according to this, banks would not have been entitled to identify persons who deposit less than 300,000 HUF in cash. This provision would have been against the international regulatory trends and foreign banks' practices and also against the purpose of the law itself (impeding money laundering).

We explained our position in the Parliament's Constitutional Committee and reviewed the issue with the Ministry for National Economy. Finally the Ministry accepted our position and the law was passed accordingly.

At the request of the government, a subsequent amendment to the legislation was enacted (apparently to simplify the purchase of government bonds by foreigners) to allow the customer to open a cash account linked to a securities account by scanning and sending by e-mail a copy of his ID document to the bank, without having to appear at the bank in person. This is possible in cases where the customer already has an account with another bank with appropriate AML policies in place. The new bank will verify the identification data provided by the customer with the other bank.

Photocopying of ID documents

The head of the National Data Protection Authority wrote a letter calling on banks to stop the practice of copying ID documents when identifying customers. Previously, there was an exchange of letters on this issue, however, we were not able to convince the Authority. The issue has been put into a new perspective with a new provision of the Anti-Money Laundering Act, requiring banks to, in certain cases, accept scanned photocopies of ID documents, sent remotely by the customer.

6. Communications

General statistics

The Association continued to conduct active communications in the first quarter, with regular appearances in the media. In Q1, we had 820 media appearances on issues affecting the banking community. As was the case in the previous periods, the most frequent were our appearances in the online media, in 470 instances, followed by the print media, in 260 instances, and the electronic media, in 80 instances. Altogether, we had more than 1200 appearances and mentions in the media in 2012.

The number of approaches from customers jumped in Q1. Most inquiries were related to the Exchange Rate Cap Scheme.

Joint campaign to publicise the Exchange Rate Cap Scheme

The Exchange rate Cap Scheme offers a solution for a major part of customers with foreign currency-denominated loans. Due to the low take-up rate of the scheme, at the end of 2012 Parliament extended the application deadline for the Exchange Rate Cap Scheme to March 29, 2013.

To ensure that the highest possible number of customers avail themselves of the scheme, and thus, promote the resolution of the situation of FX debtors, the Association launched a focused publicity campaign, drawing customers' attention to the availability and benefits of the scheme and the approaching end-date for application to the scheme. The campaign was joined by the MNB, the Ministry for National Economy and those banks involved in residential mortgage lending. PSZÁF also supported the campaign with professional information and communications.

The campaign ran from March 8 to 29, with significant TV appearances (30-second ads), online and print ads and articles. Media results show that that the information provided on the scheme reached a wide range of those affected.

Major media statistics:

- Television: the target group saw the publicity on 15 occasions on average. (OTS 15)
- PR articles: the click-through rate (CTR) was outstanding, with a maximum of 24.46%, and 10% on average (the average market CTR is 0.25%).

- Google search engine: CTR 22.7% (the average market CTR is 2%)
- Landing page turnover grew ten times (35,500 visitors in all)

In the last days before expiry, the Parliament extended the deadline for application for the scheme to May 31. Accordingly, we launched a supplementary information campaign: outdoor billboard posters (CLP) will be displayed in May to draw attention to the extended deadline. We hope that with the wide support provided, we will be able to convince the highest possible number of those eligible to join the scheme.

7. International regulation, international relations

7.1. International Developments: regulation, supervision – European Banking Federation

See detailed report in the Annex.

7.2. EBF Payments Systems Committee

The Committee's operations in the first quarter were focused on current issues:

- With the February 2014 migration deadline, the delay in preparations for SEPA, especially among bank customers, in particular in the retail and SME sectors, is a serious concern. Even in those member states which are strongly committed to SEPA, the delay in implementation of the SEPA Direct Debits Scheme is so great that it might jeopardise migration.
- The issue of a regulation to reduce bank card interchange fees is on the agenda in several member states. The Payments Systems Committee sees the situation as one of concern, since it would entail a radical decrease in profitability, putting the future of the card business at risk.
- The Committee welcomed the ECB Recommendation on payment account access services. However, it stressed the need for appropriate legal regulation and supervision. Also, the Committee pointed out the need to ensure that the account holding institution is informed about the customer or a third party having access to account information concerning a particular transaction.
- The Committee had reservations about the EU regulatory proposals regarding bank accounts:
 - Regarding the European Commission's Recommendation on basic payment accounts, intervention is only needed in cases where national measures have proved to be ineffective.
 - The self-regulation on bank account switching, supported by the EU authorities, has been implemented in all member states. Accordingly, only measures reinforcing implementation would be warranted.
 - The comparability of bank accounts can be promoted through authority measures, but an EU-wide regulation is made difficult by the divergence in national practices. Overall, the Committee saw little reason for any new regulation.

8. Association events

8.1. General Meeting

The Association held its annual General Meeting on March 22, 2013. The General Meeting adopted the following key decisions.

New Rules of the Hungarian Banking Association

The General Meeting adopted the Association's new Rules. Under these, the Association's newly defined objectives are to improve the quality of financial services, strengthen customer confidence and promote fair competition between financial institutions. An important objective is to publicise the role of the banking sector in the economy and increase the number of informed customers by promoting financial literacy.

The Association seeks to represent the widest possible range of players in the financial intermediary system. The new Rules create the conditions for this and implement the changes required pursuant to the new Act on the Right of Association.

Elections

The General Meeting elected Dr Mihály Patai as President and confirmed Dániel Gyuris as Vice-President. The General Meeting also elected György Zolnai, President & CEO, Budapest Bank and Éva Hegedűs, CEO, Gránit Bank (the latter representing small and medium-sized banks on the Board) as new board members, filling recent vacancies on the Board. The current Board's term of office expires on the 2014 General Meeting. The current Board is made up as follows:

- Dr Mihály Patai - President
- Dániel Gyuris - Vice-President
- Hegedűs Éva
- Radován Jelasity
- Hendrik Scheerlinck
- Heinz Wiedner
- Zolnai György

Awards

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

- Zsuzsanna Péter Berecz (K&H Bank)
- Dr Zsolt Lajer (Commerzbank)
- Dr István Ónody (OTP Bank)
- Dr Edina Parkánszki (ERSTE Bank)

Election of arbitrators to the Permanent Court of Arbitration of Money and Capital Markets

The General Meeting elected new arbitrators to the Permanent Court of Arbitration of Money and Capital Markets, for a six-year term commencing July 1, 2013. Previously, the Association's Board, under its powers set out in the Arbitration Court's statutes, elected the Court's presidium and endorsed the proposed amendments to the Court's internal procedures.

8.2. Conference on IFRS9

On March 25, 2013, the Association and PwC Hungary organised a conference for banks on IFRS 9 Financial Instruments. It was in 2008 that the IASB and the FASB decided to reduce the complexity of the accounting standards for financial instruments and replace the current IAS 39 Financial Instruments: Recognition and Measurement standard with a new IFRS 9 standard. The development of the IFRS 9 standard commenced in three phases. The new standard is planned to take effect on January 1, 2015. Phase 1 is Classification and Measurement, reflecting the fact that financial products are accounted for based on classification and measurement. Phase 2 provides for the Impairment Methodology and Phase 3 sets out the rules for Hedge Accounting.

In November 2012, the IASB launched a public consultation on proposed changes to the IFRS 9 rules on classification. A presentation on this proposal, which also affects Hungarian banks, was held at the conference by Yulia Feygina (practice fellow), an associate of the IASB, who is directly responsible for one of the projects. Additional topics included the proposed changes to the impairment methodology and their interrelation with Basel II as well as other important changes to the IFRS (hedge accounting, leasing). Presentations on these issues were held by Enikő Könczöl (PwC London) and Gábor Balázs (PwC, Budapest).

8.3. Working Group on Cash Payments re-established

The retirement of the head of the working group made it necessary to adopt new rules of procedure, elect a new head and allow banks to nominate new members to the working group. CIB Bank's manager responsible for cash processing was elected as head of the working group.

8.4. Data Protection Working Group

The Working Group's meetings in the first quarter were focused on drafting a proposal for sector-specific data protection regulations and the interpretation of the latest ruling of the Data Protection Authority on the photocopying of ID cards (Ruling No. NAIH-988-9/2012/V of March 13, 2013). Also, we submitted proposals to the Justice Ministry for amendments to the Privacy Act (Act CXII of 2011).

INTERNATIONAL DEVELOPMENTS: REGULATION, SUPERVISION- EUROPEAN BANKING FEDERATION

I. Global regulation

Apart from the agreement reached in January on liquidity rules¹, there were no significant developments in the area of global regulation in the first quarter of the year. The regulatory bodies continued to work on ongoing issues.

The *Financial Stability Board* (FSB) prepared a report to the G20 Finance Ministers and Central Bank Governors on ***the effect of financial reforms on the availability of long-term investment finance***. The report concludes that the global regulatory reform programme, which aims to create a safer, sounder and resilient financial system, is basically supportive of long-term investment, although it undoubtedly changes its conditions. The FSB has identified a number of internationally agreed post-crisis regulatory reforms and other national or regional policy measures that may affect long-term finance. These are in different phases of implementation and include Basel III, OTC derivatives market reform and the regulatory and accounting framework for different types of institutional investors. Some other reforms – accounting rules for banks, policy measures for global systemically important financial institutions (G-SIFIs), and policy recommendations to strengthen the oversight and regulation of the shadow banking system – have also been noted in this context even though they are still in the policy development stage. In relation to market and emerging market economies, the FSB concludes that the development of domestic non-bank financial institutions and capital markets is a long-term process that requires proper planning and commitment as well as appropriate prioritization and sequencing. The development of capital markets requires a number of important building blocks, such as strengthening the legal and regulatory framework, developing short-term money and government securities markets and instruments to hedge exchange rate risk, expanding the domestic investor base, strengthening market infrastructure, and promoting local currency corporate bond markets.

Out of the consultative documents issued by the Basel Committee on Banking Supervision (BCBS) in the first quarter, the one on liquidity management and the consultative document entitled **“Supervisory framework for measuring and controlling large exposures”** should be highlighted. The latter would replace the Basel Committee's 1991 guidance. The proposal goes beyond credit risk and addresses the assumption of large exposures as a whole. Large exposures regulation has arisen as a tool for containing the maximum loss a bank could face in the event of a sudden counterparty failure to a level that does not endanger the bank's solvency. Based on the lessons learned from the financial crisis, the BCBS seeks to mitigate the risk of contagion between systemically important financial institutions (SIFIS), in other words, to avoid that material losses in one systemically important financial institution (SIFI) can trigger concerns about the solvency of other SIFIs. The

¹ See our Q4 2012 report

consultative document also makes proposals for the oversight and regulation of the shadow banking system, in particular, policy measures to capture bank-like activities conducted by non-banks that are of concern to supervisors. The proposed new standards are aimed to provide banks and supervisors with more consistent guidance for the measurement, aggregation and control of exposures to a single counterparty.

Additional documents issued by the BCBS in the first quarter include the following:

- Principles for effective risk data aggregation and risk reporting,
- Regulatory consistency assessment programme (RCAP) - Analysis of risk-weighted assets for market risk,
- Mortgage insurance: market structure, underwriting cycle and policy implications - a consultative paper released by the Joint Forum,
- Margin requirements for non-centrally cleared derivatives - Second consultative document,
- Supervisory guidance for managing risks associated with the settlement of foreign exchange transactions,
- Results of the Basel III monitoring exercise as of June 30, 2012,
- External audits of banks - consultative document,
- Recognising the cost of credit protection purchased – consultative document.

II. European Union

II.1 Banking union

Following the agreement in the European Parliament's Economic and Monetary Committee (ECON) and the Council of Finance Ministers (ECOFIN), the trilogue on the proposed Single Supervisory Mechanism (SSM) commenced before Christmas. According to reports, the Council represents a tougher position on the regulation appointing the ECB the single European regulator (not requiring the formal consent of the European Parliament). In return, the European Parliament's trump card is the regulation on the European Banking Authority, which is subject to a co-decision process.

The EBF has identified the following key issues in relation to the proposed SSM:

- (i) The need for a consistent and high quality supervisory approach for all banks, no two-tier supervision, specification of the supervisory methods defined by the ECB,
- (ii) The ECB's decision regarding national discretions,
- (iii) The right to determine capital buffers and additional capital requirements,
- (iv) Banks should not end up paying twice for local and EU supervision,
- (v) Banks should have the right to appeal ECB supervisory decisions,
- (vi) A deadline should be set for ECB supervisory licensing.

Items (v) and (vi) are on the agenda of the trilogue, the issue of double payment of supervisory fees is not and the issues of two-tier supervision and the elimination of national discretions are partially present in the proposals tabled. The Council's text would split the powers to determine capital buffers between the ECB and national supervisors. This is against the single rule book and the EBF is strongly opposed to this proposal. The EBF explained its position on the above issues in a letter to participants in the trilogue.

According to information received in the middle of March, the trilogue was focused on issues related to the division of work between the ECB and national supervisors, close cooperation by the ECB with non-euro-zone member states, appointment of the Chair and Deputy Chair of the Supervisory Board and the rotation of the Steering Committee. Key issues related to the EBA Regulation included

voting, the frequency of stress tests, the EBA's role in colleges of supervisors and the legal status of the single supervisory manual. The ECOFIN is expected to vote on the SSM in April or on May 14, the EP vote is scheduled for May 21.

According to preliminary information, 130 bank groups (comprising about 280 legal entities) will be subject to direct supervision by the ECB. To ensure legal certainty, all affected entities will receive a relevant resolution from the ECB. The deadline for the implementation of ECB supervision is June 1, 2014.

II.2 Agreement on the capital and liquidity frameworks – CRR/CRD4

The Irish presidency addressed the trilogue on capital requirements and liquidity management as a key priority and it sought to conclude it in the first quarter of 2013. This was achieved, with members states coming to agreement on the CRR and CRD4. In relation to the priorities identified by the European Banking Federation, the agreement contains the following:

Key elements of the flexibility package for national authorities to impose stricter national measures:

- Authorities may apply systemic risk buffers in three categories:
 - Buffer for global strategically important institutions (G-SIFIs). This will be similar to that defined by the Basel Committee, in terms of both definition and criteria (1%-3.5%). In certain cases, member states will be able to apply higher buffers.
 - Buffer for other SIFIs (O-SIFIs): the criteria are consistent with those of the Basel Committee, the buffer will be capped at 2%. If the O-SIFI is a subsidiary of a G-SIFI or an O-SIFI group, the higher of a 1% cap or the rate to be applied on a consolidated basis will apply. (The above two buffers will be phased in from 2016).
 - Systemic risk buffer (SRB): this is aimed to reduce counter-cyclical and macro-prudential risks in the financial sector or in one or more segments of it. The authorities responsible for setting the buffer in their jurisdictions will be appointed by the member states. The responsible authority may impose a systemic risk buffer of up to 3%. The national authority shall notify the EU authorities and give the reason for the buffer. For a systemic risk buffer between 3% and 5%, the European Commission's approval shall be sought. This buffer shall be added to the G-SIFI and/or O-SIFI buffers, if the risk buffer is applied to domestic exposures only. (The SRB will be introduced concurrently with the entry into force of the CRR/CRD4).
- Macro-prudential supervisory package: in addition to capital buffers, the regulation will allow member states to impose macro-prudential measures to address systemic and macro-prudential risks, including in such sensitive areas as the level of own funds, the level of the capital conservation buffer and the risk weights for residential and commercial property. At the proposal of the Commission, to be agreed with the EBA and the European Systemic Risk Board (ESRB), the Council may reject stricter national measures proposed by a member state.

Minority interests: Favourable compromise reached. Minority interests can be recognised at the consolidated level.

SME exposures: Favourable compromise reached. An SME lending supporting factor of 0.7619 will be introduced for SME exposures and the exposure limit will be increased from EUR 1 million to EUR 1.5 million. These measures will be reviewed after three years.

Credit Valuation Adjustment (CVA): Favourable compromise reached. Intra-group transactions and exposures to sovereigns, central governments, international organisations, pension funds and non-financial companies will be exempt.

Deferred tax assets: Compromise not fully satisfactory. Deferred tax assets can only be recognised if the national regulation allows use in case of losses, insolvency and winding up alike. The EBF is of the view that winding-up should be sufficient for recognition.

Liquidity requirements: Compromise consistent with the BCBS document, basically advantageous, but controversial, primarily in relation to the liquidity inflow limit and the EUR 1 million limit for SME deposits.

The short-term liquidity ratio will be phased in between 2015 and 2018 by a delegated act. Member states may apply liquidity requirements until the LCR is fully phased in.

Prudential filters: Favourable compromise reached. The current prudential filters will remain.

Trade finance: Favourable compromise. Trade finance and export credit will be appropriately recognised in capital requirements, leverage ratio and liquidity.

Basel I floor: Unfavourable solution. The floor remains. National authorities may give an exemption from the floor.

Deductions from capital (software): Unfavourable solution. Software shall be deducted from capital. The EBF will continue to lobby during the implementation period for a level playing field solution.

Loss Given Default (LGD) ceiling: Unfavourable solution. National authorities may increase the ceiling (currently 10% for residential mortgages and 15% for commercial mortgages). This issue is linked with the macro-prudential supervisory package.

Weighting of exposures to central governments and central banks denominated in the currency of a member state: Favourable compromise. Same weights as those for own currency can be applied until 2017. After that, higher weights will be phased in gradually.

A key political issue during the negotiations was the remuneration of management. Finally, it was agreed that the fixed to variable remuneration ratio shall not exceed 1:1. The shareholders may increase this ratio to 1:2 (with 66% of the votes in the case of a quorum requirement of 50%, or with 75% of the votes if there is no quorum requirement or the number of those present is lower than the quorum requirement). Where the ratio of variable remuneration is greater than 1, at least a quarter of the bonus shall be deferred for at least five years. (Taking into account the discount, this may significantly increase the 1:2 ratio). The Commission will review the impacts of these restrictions after two years.

Transparency. Banks will be required to disclose, by country, their profits, taxes paid and subsidies received, sales and staff numbers. These data shall be reported to the Commission from 2014 and disclosed from 2015.

Implementation. The European Parliament passed the CRR/CRD4 on April 16. Accordingly, this important piece of legislation, determining the operating conditions of European banks will by all probabilities enter into force on January 1, 2014.

II.3 Bank Recovery and Resolution Directive (BRRD)

The European Parliament submitted to the ECON more than 1600 amendment proposals. 46 out of the 54 proposals made by the EBF are included in the amendment proposals. Of these, the following enjoy strong support:

- Reaffirming the confidentiality of Recovery and Resolution Plans (RRPs).
- Prevention, early intervention and resolution tools should be clearly defined and proportional.
 - The use of early intervention tools and the recovery phase should not be public.
 - The special manager (similar to the supervisory commissioner) should only be involved in the resolution phase.
- The bail-in tool should be used in the recovery phase as a last resort.

The following proposals enjoy limited support:

- The number of authorities to be involved in the recovery colleges should be limited to 1 per member state and the participation of third-country authorities should be ensured.
- Recovery plans should only be required to be prepared at the group level.
- Supervisors should only be allowed to interfere with the structure or operations of financial healthy financial institutions to a limited extent.
- The positions on the application of the bail-in tool and funding of the resolution are divergent, with contradictory amendment proposals.

The Irish presidency prepared several discussion documents for the relevant work meetings within the European Council. These address issues related to the appointment of a special manager, home-host issues, proportionality, the use of the bail-in instruments and the funding of the resolution.

The second compromise text proposal was published in January. The biggest debate is around the bail-in instruments, the role of home vs. host supervisors and the question of whether a designated bail-in category or a broad range of instruments should be used.

According to the timetable, after a vote in the ECOFIN and then in the ECON, the European Parliament is to vote on the proposal on June 10. The Directive is closely linked with the banking union proposal and the Deposit Guarantee Schemes Directive.

The discussion on the Deposit Guarantee Schemes Directive (DGS) has been suspended after MEPs deciding in February 2012 to have a second reading. The text proposed by the European Parliament would provide depositors with more protection and set higher fees (of up to 2.5 times the average fee) for riskier banks. Member states say the fee should depend on the size of deposits. There is also a debate concerning the funding level (EP proposal: 1.5%, member states' proposal: 0.5%).

II.4 Proposals for possible reforms to the structure of the European banking sector

II.4.1 Developments related to the proposals of the High-Level Expert Group (HLEG)

According to the original plan, the College of Commissioners was to decide before Christmas or in early 2013 on how the proposals presented by the High-Level Expert Group led by Liikannen, Governor of the Bank of Finland, should be further addressed. The decision was postponed. Instead, a new unit was established at DG Markt to address the proposal and conduct an impact study. The Council's Financial Services Committee discussed the HLEG report and the ECOFIN was also informed on the contents of the report. The issue is not a priority on the Irish presidency's agenda.

II.4.2 EBF position

Out of the five recommendations made by the HLEG², the EBF focuses on the mandatory separation of trading activities over a certain value. For the purpose of lobbying, the EBF compiled a Key

²The five recommendations:

1. Mandatory separation of proprietary trading and other high-risk trading activities over a certain threshold.
2. Possible additional separation of activities conditional on the recovery and resolution plan
3. Possible amendments to the use of the bail-in instruments as a resolution tool.
4. Review of the capital requirements on trading assets and real estate related loans
5. Strengthening banks' governance and controls

Information Document (KID), which will be communicated to MEPs and financial attaches. The EBF is seeking cooperation with other advocacy organisations to jointly draw attention to the negative impacts the mandatory separation of trading activities would have on lending and growth.

In Germany, the various banking associations, jointly with and industrial and commercial associations, issued a statement in defence of universal banking.

Key proposals of the EBF:

- High-risk trading activities (proprietary trading activities with no link to clients' needs) should be regulated by other means rather than mandatory separation.
- The EBF supports the HLEG recommendation to further strengthen the use of Recovery and Resolution Plans (RRPs), as it fits better with the current regulatory reform agenda and can be incorporated with a considerably less distortive impact than mandatory separation.
- The separation of trading activities conditional upon the RRP should be the last resort and should not be imposed on banks that are going concern.
- The supervision of high-risk trading activities is key. The Single Supervisory Mechanism, complemented with the three European supervisory authorities and the European Systemic Risk Board significantly strengthen the micro and macro-prudential supervision of European banks.
- With regard to the recommendation for an extra non-risk based capital buffer for the trading book on top of the risk-based requirements (Basel II.5 and Basel III), the EBF considers that any additional steps in this direction should await the finalisation of the review of the trading book and take into account the buffers already proposed in the CRD4/CRR.
- The HLEG does not address the potential economic consequences of implementing the proposed mandatory separation of trading activities, in particular, the higher costs that would hit banks. Hence, the EBF calls for an impact assessment of any legislative proposals.

II.4.3 ECON own initiative report on reforming the structure of the European Banking Sector

In the context of the recommendations of the HLEG, the European Parliament's Economic and Monetary Affairs Committee prepared an own initiative report on reforming the structure of the European banking sector. The report supports the mandatory separation of trading activities through the establishment of a thorough, transparent and credible ring fence around bank activities that are vital for the real economy, such as those relating to credit functions, payment systems and deposits. The report urges the Commission to ensure that trading activities do not benefit from implicit guarantees and the use of insured deposits or taxpayer bailouts. Separation should result in separate legal entities, with separate sources of funding. There should be no legal basis for shifting capital and liquidity from ring-fenced entities to other entities in the group. Separate capital, leverage and liquidity rules should be applied to each entity, including separate balance sheets. The report proposes that there should be large exposure limits set for intra-group transactions between ring-fenced and non-ring-fenced activities, which are at least as strict as those for third-party exposure. Also, it should be ensured that the ring-fenced entity has sufficient capital and liquid assets to enable it, in the event of the bank's failure, to maintain depositors' access to funds. The report supports the proposals set out in the HLEG's report in the area of corporate governance of separated banks. It proposes additional restrictions on remuneration and the implementation of effective sanctioning regimes. To enhance competition, the report proposes to promote greater diversification of the European banking sector through various banking models. Also, it points out the need for measures to facilitate consumer switching between banks and reducing the barriers to entry.

Apparently, the European Parliament's stance taking shape is contrary to the EBF's position, which proposes to await the results of ongoing legislative activities. During its lobbying activities, the EBF has found that MEPs have serious concerns regarding the cross-subsidisation of trading activities, the "too big to fail issue", the use of taxpayer money for bail-out, the unsustainable risk culture of banks and the lack of competition.

II.5 European Commission report on the Financial Conglomerates Directive (FICOD)

In January, the European Commission published a report, outlining how the Commission plans to proceed during the review of the FICOD.

- Certain important issues have been/will be addressed through other regulations (such as the treatment of systemically important groups and recovery and resolution tools).
- Given that the FICOD is of a supplementary nature, the Commission will await the review of the relevant sector (banking, investment firms, insurance).
- The Commission has identified those areas, which need to be improved (extension of the scope of supervision to unregulated entities, thresholds for identifying a financial conglomerate, coverage of industrial groups owning financial conglomerates, imposition of appropriate reporting and disclosure requirements, extension of the corporate governance rules to the head of the conglomerate, a European-level legislation to provide for enforceability of the FICOD, introduction of mandatory stress testing to capture the specific risks of financial conglomerates).

II.6 Amendment to EU Regulation No. 1060/2009/EC on Credit Rating Agencies (CRAs)

After reaching a trilateral agreement on the issue, the European Parliament in January passed an amendment to the Regulation on CRAs. The amendment is expected to take effect in the summer of 2013. The next step will be for the European Securities Markets Authority (ESMA) to create a European credit rating platform to provide for the comparability of CRA ratings of companies and instruments. In addition, Regulatory Technical Standards will have to be developed for the contents of ratings and a website established for information on structured financial instruments. The European Commission should, by July 1, 2016, prepare a report on the credit rating market, with a proposal for additional regulatory measures, if necessary.

III. European Banking Authority (EBA)

III.1 Standard-setting and other activities related to CRR/CRD4

III.1.1 Data point model for the Implementation Technical Standards on supervisory reporting requirements (COREP/FINREP)

In the middle of March, the EBA – at the request of the sector - published an ***updated (but not final) version of the reporting requirements based on the current versions of the CRR/CRD4***. By publishing these non-final ITS, the EBA has sought to assist banks in implementation, while emphasising that the templates, related instructions and data point models contained in the ITS do not represent final proposals. The final version of the ITS will be published in the EU Official Journal after adoption of the CRR/CRD4. The requirements are expected to be first applicable to Q1 2014

reports. The updated package contains templates, related instructions, data point models and frequently asked questions and answers.

In addition to the mandatory reporting requirements, the EBA drafted a proposal for ***data point models for Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio***. This proposal is a follow up to the consultation conducted in 2012. Comments are invited by May 13, 2013.

In relation to reporting requirements, at the end of March the EBA launched an additional two consultations on reports complementing and later, becoming part, of FINREP. The ITS on asset encumbrance reporting is aimed to provide supervisory authorities with the necessary information on the level of asset encumbrance in institutions (secured financing transactions, collateral agreements, repurchase agreements, etc.). The other reporting requirement relates to ***forbearance and non-performing exposures***. The proposed definitions and templates, once implemented, will allow European supervisors to:

- assess the extent of forbearance transactions and their effects on asset quality and loss recognition,
- capture asset quality deterioration,
- compare asset quality on a more consistent and homogeneous basis across EU institutions.

The consultations run until June 24, 2013, a joint public hearing on the two topics will be held on May 27. Naturally, these ITS may only become final once the CRR and CDR4 are adopted.

III.1.2 EBA discussion papers on liquidity

On February 21, the EBA issued two discussion papers related to the Liquidity Coverage Ratio (LCR). One is on the identification and classification of liquid and highly liquid assets and ranking of the relative liquidity of the different asset classes. The other discussion paper is on retail deposits subject to higher outflows for the purposes of liquidity reporting under the Capital Requirements Regulation (CRR). This paper is aimed to ensure a consistent and comparable measure of outflow rates across institutions.

The ***EBF's view*** is that in determining liquid assets, the European Central Bank' guideline on monetary policy instruments and procedures should be applied. In relation to outflow rates, the Basel III accord should be adhered to. The application of higher values is unwarranted from a level playing field point of view.

III.1.3 Consultation on draft Regulatory Technical Standards aimed at specifying the conditions for assessing the materiality of extensions and changes to internal approaches when calculating own funds requirements for credit, market and operational risk

Institutions shall apply for permission whenever they intend to implement any material extension or change to their internal approaches. The proposed Regulatory Technical Standards are aimed at harmonising the assessment of the materiality of extensions and changes to the institution's internal approaches and to ensure that its approved internal approaches comply with the regulatory requirements.

III.1.4 Basel III monitoring exercise

In March, the EBA published its regular semi-annual report on the Basel III monitoring exercise. (The monitoring exercise assumes full implementation and is based on statistic balance sheets). According to the results of the exercise, for the 44 Group 1 banks, the average CET1 ratio would fall from the current 11.1% to 7.8%. The CET1 capital shortfall is EUR 3.7 billion at the minimum requirement and EUR 112.4 billion at the target level. Compared to the previous period (reporting date as of December 2011) the aggregate CET1 shortfall of Group 1 with respect to the target level improved by EUR 86.2 billion. This improvement is primarily attributable to the increase in capital rather than the decrease in risk weighted assets. (Due to changes in the liquidity regulations, the report does not contain LCR calculations).

III.1.5 Interim report on the consistency of risk-weighted assets in the banking book

After finalising the 2011 EU-wide stress test and the recapitalisation exercise, the EBA turned its attention to understanding RWA. The interim report is aimed to identify whether there are material differences in RWA outcomes and, if so, to discover the sources of these differences and whether they are justified by fundamentals or are related to differences between banks and supervisory practices. The EBA points out that differences in risk parameters and capital requirements between banks are not a sign of inconsistency per se. The composition of portfolios may differ across banks as the result of differences in markets, risk appetite or borrower selection criteria. However, a substantial divergence between banks may signal that the methodologies used for estimating risk parameters by some banks will require further analysis.

III.2 EBA activities related to the Bank Recovery and Resolution Directive (BRRD)

In January, the EBA adopted a formal Recommendation to ensure that major EU cross-border banks develop **group recovery plans** by the end of 2013. The recovery plans should be drafted in accordance with the October 11 document of the Financial Stability Board and the EBA discussion paper of May 2012. The plans should be submitted to the authority responsible for the supervision of the group. The plans will be reviewed by the relevant colleges of supervisors. The home supervisors of the 39 bank groups involved shall notify by March 23, 2013 the EBA as to whether they comply or intend to comply with the recommendation.

In March, the EBA launched a consultation on **Draft Regulatory Technical Standard (RTS) for recovery plans**. With this, the EBA has started the preparatory work for the implementation of the Bank Recovery and Resolution Directive (BRRD). The proposed RTS will be part of the European Single Rulebook and aim at enhancing financial stability and minimising the probability of bank failures. The consultation runs until June 11, 2013. According to the proposed RTS, recovery plans developed at group and individual level will need to include at least the following 5 key parts:

- Summary of the recovery plan;
- Governance, including the conditions and procedures necessary to ensure a timely implementation of the recovery options;
- Strategic analysis, including a description of the institution's core business lines and critical functions together with the different recovery options designed to respond to financial stress scenarios;
- Communication plan, including external and internal communication arrangements; and

- Preparatory measures taken or to be taken to improve the implementation and effectiveness of the plan.

(The contents proposed in the RTS are consistent with the EBA Recommendation issued in January 2013 to foster the development of group recovery plans). The draft RTS might be amended to take account of possible changes in the final BRRD.

III.3 EBA risk assessment

In discharging its responsibility under its founding Regulation, **the EBA assesses risks and vulnerabilities in the EU banking sector** on a semi-annual basis. According to the January assessment report, since the last assessment report, (July 2012) the EU banking sector has seen some improvement in market confidence from both debt and equity investors. Nevertheless, these signals may prove temporary and the macroeconomic environment for most European banks remains fragile, especially for banking systems in countries where the sovereign itself is financially-stressed. Thus, serious challenges remain due to increasing credit risk and low profitability levels that could be further depressed by rising loan-loss provisions.

The risk appetite of banks is changing and business models are adapting both due to internal drivers as well as in response to regulatory and market developments. Although there is variation within Europe, de-risking is proceeding, although at a slower pace than in other parts of the world, especially insofar as assets related to the real economy are concerned. EU banks have significantly strengthened their capital positions. However, concerns remain about the impact on capital of future loan losses. The emerging new regulatory landscape can create the framework for a more resilient banking sector. The crisis has had a material impact on cross-border banking, a pan-EU fragmentation and retrenchment within national boundaries by the larger cross-border banking groups potentially leads to market inefficiencies and to an erosion of the single market.

III.4 Consumer trends report

Under its consumer protection function, the EBA publishes annual reports on trends in the areas of consumer protection and financial innovation. The first part of the current report presents consumer protection activities carried out by the EBA and other European institutions and in member states in the banking sector, based on surveys conducted among the national authorities. The report updates the main consumer protection issues by taking into account the issues identified during the survey carried out in the second half of 2012. These include:

- Indebtedness and responsible credit;
- Transparency and levels of charges;
- The scope of mis-selling of financial products (resulting from a combination of pressures on institutions and the continuing challenges for consumers in understanding the suitability of products for them);
- Specific issues concerning certain products – notably foreign currency loans, payment protection insurance and complex products;
- Security of new technologies used for banking services; and

- Emerging new forms of liquidity raising.

Some member states have introduced further requirements and standards to address these issues and the EBA is currently also working to produce good practices on responsible lending and on the treatment of borrowers in payment difficulties.

III.5 EBA - ESMA joint action to strengthen Euribor and benchmark rate-setting processes

In January, the EBA and ESMA published the results of their joint work on Euribor and proposed principles for benchmark rate-setting processes. These include:

- A review of the administration and management of Euribor and recommendations to the Euribor-European Banking Federation to improve the governance and transparency of the rate-setting process
- Formal EBA Recommendations to national authorities on the supervisory oversight of banks participating in the Euribor panel; and
- A joint ESMA-EBA consultation on principles for benchmark setting processes in the EU, to establish a framework for the conduct of benchmark rate-setting and the activities of participants in the process.

Euribor-EBF is committed to strengthening the administration and control of Euribor. The European Commission is considering a legal obligation for banks to participate in Euribor. Euribor-EBF considers this as a sensible precautionary measure against which there can be no objection.

In addition to the above, the EBA issued a best practice document on the risk management of funds traded on the stock exchange. The document is an opinion, which is not legally binding.

IV. European Banking Federation - EBIC³ - IBFed⁴

IV.1 EBF letter to the EP rapporteur on the BRRD

In its letter to the EP rapporteur, the EBF points out that the BRRD will contribute to strengthening stability and reducing the financial sector's dependence on governments and promote the development of the internal market. The success of the Single Supervisory Mechanism (SSM) depends on how cross-border cooperation regarding the BRRD will work, since this will facilitate moving towards an SSM. The EBF agrees that a special manager should not be appointed in the phase of early intervention, as that would signal to the market that the institution is heading for a resolution, which would further damage its financial position. Deficiencies in the RRP do not provide a ground for the supervisor to require the changing of the business strategy.

Banks should be given the right to challenge the decision of the authority before a court.

³ European Banking Industry Committee: the joint committee of European financial industry associations

⁴ 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).

RRPs should be prepared at the group level, but RRP at the individual level should also be allowed (subject to management's decision and agreement by the supervisory authority).

Recovery and Resolution Plans are commercially highly sensitive, therefore, the EBF supports the imposition of strict confidentiality requirements.

The European Parliament should not reduce the scope of application of the BRRD to systemically important banks. At the same time, proportionate application relative to the size and complexity of the bank should be allowed.

The scope of bail-in should not be extended to institutions that are going concern. The involvement of senior liabilities in the resolution should be a last resort and take place in the resolution phase and not in the recovery phase.

There should be no requirement for firms to hold a specific proportion of their Total Liabilities as bail-in instruments. There should not be a one-size-fits-all minimum.

The various crisis management phases (early intervention, recovery, resolution) should be legally clearly defined. The EBF proposes that the trigger should be reduced to capital and liquidity ratios and the supervisory authority's subjective decision.

The EBF supports a harmonised solution for resolution funding and is not convinced about the need to create national ex-ante resolution funds.

The BRRD and the DGSD should be harmonised and made consistent.

In case of cross-border groups, effective cooperation between member state/third country authorities is necessary, based on the one authority per one country principle and led by the home supervisor. Resolution Colleges should be headed by the home supervisor, while keeping the host supervisor informed. The BRRD sets out a resolution framework for each of the 27 member states. However, there will only be one resolution framework in the Banking Union.

IV.2 EBF proposals related to the EBA stress test

In preparing for the 2013 stress testing exercise, the European Banking Federation set up a working group from specialists from banks involved in the test. The working group formulated the main expectations from the test, including its objective, scope, procedure and schedule and the communication of the results of the test. The EBF's comments also address the assumptions and scenarios and the regulatory framework to be used as a starting point. According to the working group, there is no need for a pass mark. At the same time, the working group sees a need to take into account the interaction with other stress tests.

IV.3 EBF response to the BCBS on revisions to the Basel Securitisation Framework

In its comments, the EBF emphasises that the revision of the prudential treatment of securitisations is one of the most delicate elements of the regulatory reform underway from a European viewpoint. The EBF understands the Committee's intention to set up a stable framework for the prudential treatment of securitisation exposures. However, it suggests that the BCBS first evaluate the improvements achieved in the EU securitisation market with the legislation enacted since the start of the crisis before embarking on any new changes. The proposed overhaul of the capital requirements framework for securitisations would have undesirable consequences in a market that is essential to the funding of the real economy.

The proposed changes and the basis for calibration do not reflect the characteristics of securitisation instruments originated in the EU. As a result, EU banks' funding capacity could be severely damaged. The EBF suggests that the BCBS should revisit the suggested calibration to take account of the rest of the measures in place. As for the priority of the proposed methodologies, the EBF recommends that an alternative hierarchy is considered.

IV.4 IBFed response to the FSB consultation on shadow banking

In January, the IBFed gave its comments on the FSB's documents on shadow banking in a single letter. The IBFed pointed out the following:

- The different shadow banking documents of the FSB and IOSCO contain some overlaps and inconsistencies. These should be eliminated.
- The proposals will have a considerable impact on end users.
- The artificial elimination of references to external ratings creates perverse incentives and decreases risk sensitivity.
- The proposals related to funds (hedge, private equity, money market, credit funds) would significantly increase the costs and limitations of the funds in question and may have far-reaching consequences not only for the funds in question, but for end users and in particular, for pension funds and their beneficiaries.
- The benefits of securitisation and the importance of private equity should not be underestimated.
- The haircuts for securities lending and repos should be reconsidered. Reporting requirements should be aligned to ensure global consistency. While trade repositories may offer transparency benefits, they are likely to be costly to implement and operationally complex.

IV.5 IBFed comments on the treatment of large exposures

In relation to the treatment of large exposures, the IBFED sent the following key messages to the BCBS:

- The variations in banks' practices are valid and expected, given differences in banks' internal processes, business models and risk appetites. The BCBS should minimise the impact on banks' processes and businesses of any rules that are going to be proposed, by either allowing firms to utilise their internal management models for measuring exposures, or the internal models they have developed for regulatory capital purposes.
- Banks' current internal measures are significantly more robust and the governance much stronger than those used before the crisis. In addition, internal measures are subject to rigorous validation processes.
- Any constraints on the intragroup movement of capital and liquidity could have significant impact on existing structures of banking groups. Restrictions on intragroup exposures could make it challenging to recapitalise important subsidiaries when needed.
- In capturing indirect client relationships, the experience with the existing interconnectedness framework in the EU should be studied to understand the materiality and usefulness of the information being collected.
- Establishing a regulatory limit on exposure to CCPs would therefore be contradictory to the ongoing regulatory reforms.
- The IBFed does not see any reason why exposures to systemically important financial institutions should be subject to stricter limits.

IV.6 IBFed letter to the IASB and the FASB on synchronisation of deadlines

At the beginning of the year, the IBFed wrote a letter to the international and U.S. standard setting bodies, requesting them to synchronise the comment periods for their exposure drafts on impairment exposures, to ensure that both proposals can be considered and evaluated at the same time.

IV.7 Reporting and disclosure requirements

In January, the EBF wrote a letter to the EBA, requesting it to publish an updated version for COREP, as was the case with the ITS. (As presented in III.1.1. above, the EBA did so in March.)

During the discussion of the risk disclosure proposals made by the Financial Stability Board's Enhanced Disclosure Task Force⁵, it was raised that separate requirements should be developed for the risk reporting of small banks.

The European Systemic Risk Board (ESRB) raised that the convergence of banks' reporting requirements and the disclosure requirements under Pillar 3 (potentially, the disclosure of FINREP reports) would be useful with a view to ensuring comparability and the exploitation of potential synergies. The EBF is to review the issue with the ESRB in May.

⁵ (For more on the EDTF see the Annexes to our Q2-Q4 2012 reports)