

REPORT

on Activities of the Hungarian Banking Association

1st Quarter 2016

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I. Executive summary

In Q1 of 2016 the **world economic** outlook weakened in terms of growth for both developed and developing countries. The IMF's predictions in April were lower than before for developed economies: 2.4% growth in the United States, 1.5% in the Eurozone and 0.5% in Japan. With regard to developing countries, its expectations are mixed: in China and India it predicts continued growth (6.5% and 7.5%, respectively) while it forecasts a significant drop in Russia and Brazil (1.8% and 3.8%, respectively). Since export still cannot support it, economic growth in the USA continues to be fueled by growth in the labor market and through it, by high domestic demand. In Q1, the European Union continued to show moderate GDP growth, however, due to the slowing of the Chinese economy, investment concerns resulting from a possible Brexit and the short-term unfavorable effects of immigration, external and internal growth risks increased. The extreme indebtedness and declining creditworthiness of corporations poses a significant risk to the Chinese economy (which has been growing at a slower rate than before).

There was a significant lapse in the **Hungarian economy's growth**: the GDP dropped by 0.8% on a quarterly basis, while on a year-on-year basis, growth is only 0.9%. On the production side, poor performance was due to a drop in industrial production, mainly in the construction industry (-30%). During this quarter, there was no perceptible growth in net export either. At the same time, labor market indicators improved and gross incomes grew considerably, which, together with low inflation may further strengthen domestic demand. By the end of the quarter the consumer price index once again sank into the negatives on a year-on-year basis, while during the quarter, prices increased by an average of 0.3%. Balance indicators paint a diverse picture: in Q1 the cumulative central government deficit was HUF 125.8 billion, which is only 16.5% of the appropriation for the year; however the GDP-proportionated government deficit increased from 75.3% to 76.9%. The external financing capacity of the country is extraordinarily high: 9% of the GDP. In March, the central bank decreased the reference rate by 0.15 basis points (to 1.20%). As a result, the single day deposit rate dropped to -0.05% percent. Decreasing the interest rate did not weaken the forint's exchange rate.

In Q1, the balance sheet total of **credit institutions** increased only slightly, by 0.7% in nominal terms and reached a little over HUF 33 trillion. Net loan portfolio grew by 6%, while within liquid assets the restructuring from central bank deposits to state securities supported by MNB's self-financing program continued. Impairment portfolio continued to decrease for both corporate and retail loans, by a total of HUF 63 billion (3.9%). Aside from the public sector deposit portfolios decreased in all other important segments, thus deposit portfolio shrank by 2.2% total (HUF 368 billion). Interbank liabilities grew by a dynamic 6.6% (HUF 596 billion); short-term deposits were replaced by long-term liabilities. By the end of Q1 the *net loan-to-deposit ratio* of the credit institutions sector increased to 94% (from 87% at the end of the year). In Q1 of 2016, profit before taxes was outstanding (it reached HUF 198 billion), HUF 124 billion more than in the same quarter of last year. The sector's annualized average return on assets, before taxation (ROA) was +2.4%, and its return on equity (ROE) was 25.5%, similar to the best performing years preceding the economic crisis. However, among the factors influencing these results, there are significant effects that will impair profit by the end of the year, as well as downside risks.

Based on the amendment to the Quaestor Act and the indications of the liquidators of the bankrupt brokerage firms, by early 2016, banks' and investment firms' **compensatory and claim settlement obligations** (resulting from the winding up of Buda Cash, Quaestor and Hungária) decreased compared to preliminary predictions. This could have a stabilizing effect on profitability in the long run, together with the **cutting of the banking surtax** – in accordance with an **earlier agreement**.

Concerning **retail lending**, the operative task requiring the most resources in the sector was the interpretation and implementation of the modifications to the **Family Housing Allowance Scheme (CSOK)**. Banks also paid extra attention to the **domestic legislation transposing the Mortgage Credit Directive**, which entered into force in March. Meeting the criteria of the **MNB recommendation on the restitution of retail mortgage loans affected by late payment** (which was issued in March without prior consultation and entered into force the same month) also presents banks with significant burdens. In addition there are doubts as to it proving a substantial step forward in the management of the situation of nearly 140,000 non-paying customers.

The MNB also set the management of non-performing corporate loans as a priority. In collaboration with the EBRD it launched a project for elaborating the **principles regarding the settlement of non-performing corporate loans outside the courtroom**, to be organized by the EBRD. The aim of the project is to promote the integration of the settlement of corporate debt into banking practice (based on collaboration between debtors and lenders) through the review of the Budapest principles or through the creation of another voluntary regulatory system.

Regarding **legislation**, after intense work on the **modification of the Civil Code** only a significantly reduced part of the amendment proposal elaborated by the Banking Association's expert group was submitted to Parliament. For credit institutions the most important change was that the independent lien will be reintegrated into the Civil Code from October 1, 2016. Regarding the amendments to the Civil Code, we addressed in detail the issue of the amendments to the **loan collateral register regulations**, however, the draft law was not sufficiently mature and contained contradictions; it did not make its way to Parliament. The codification committee led by the Ministry of Justice was established for this reason and it prepared the amendment to **Act LIII of 1994 on Court Enforcement**, to be submitted to the autumn session. Although **Act CV of 2015 on the Debt Resolution of Private Individuals** (personal insolvency) was amended twice after its adoption, there is still need for a comprehensive review. The Banking Association urges the radical reduction of application documentation and the regulation of a simplified debt settlement process. This law was amended in April, but only the time limit for the application for the procedure was extended; the submission of a lengthier proposal was postponed to the second half of the year. While stating its observations on the government decree concerning the sale of the debtor's assets, the Banking Association made proposals to render the procedure more market-based and to protect the interests of creditors. Concerning the amendment to Act III of 1952 on the **Civil Procedure** at the end of 2015, the issue of the introduction of the mandatory electronic liaison with courts was raised, the deadline of which had been moved to 1 July 2016 at the end of last year. The Banking Association initiated the introduction of a **company gateway** (based on the official gateway model) which provides access to several representatives of individual organizations. In January the Central Office for Administrative and Electronic Public Services contacted the Banking Association to help organize the communication of information and the training of bank employees on the introduction of the **electronic ID cards (e-ID)**.

Concerning **legislation that falls in the scope of the central bank of Hungary** (MNB), the decree on **the payment-to-income ratio (PTI)** was amended. This change, which will somewhat ease the debt brake, will enter into force on May 1, 2016. With regard to the consultation initiated for the introduction of the **Mortgage Funding Adequacy Ratio (MFAR)**, in order to promote the refinancibility of existing mortgage credit portfolio, the Banking Association proposed to amend the **Mortgage Bank Act**.

As a result of consultations early this year between MNB, the HBA and ACI Hungary, the **regulation on BUBOR quotes was modified**. In March ACI Hungary's Steering Committee decided to offer to hand over **administrative tasks in connection with BUBOR** to MNB. The central bank is open to taking over quoting and the relevant rights. This could be done in the fall of 2016 at the earliest, after

they agree on the conditions. Consultation on **remuneration** issues with the central bank's supervisory department also had positive results from the point of view of banks. The authority adopted the proposals on publication obligation related to the remuneration of senior officers and the interpretation to apply the principle of proportionality temporarily, until the establishment of EU regulation. The **formal start of operations** (under the aegis of MNB) **of the Hungarian Restructuring and Debt Management Ltd** was another important development during the quarter. The statistics department of the central bank consulted on the **changes** in its 2017 **reporting due to the transition to IFRS** with the Banking Association's working group, created specifically for this issue.

Concerning the transition to IFRS, the HBA's taxation working group prepared an amendment proposal to the regulation on **local business tax** (to modify the definition of net revenue). In connection with changes to the **regulation on auditing** (which will also concern banks), the Banking Association opposed the creation of stricter legislation than the relevant EU directive.

Regarding **payments**, the **management of direct debit for the mass transfer of clients from gas and electricity service providers** was completed without problems. The Banking Association took initiative action and played a crucial role in organizational tasks as well. Creating the **uniform XML account statement** – working to make client to client automated administration possible – is another important result. In connection with the introduction of the **new 20,000 bill** the MNB accepted banks' proposal to withdraw the old banknotes from circulation later (postponing the deadline to end-December, 2016), however the recirculation of the old bills is prohibited starting from May. Concerning **bank cards**, new developments are: the card type must mandatorily be indicated on the card; preparations have been made for the introduction of the installment repayment service; and the use of geoblocking to avoid fraud.

Hungary joined the **European Money Week** program (among nearly 30 participating countries) for the second time this year with outstanding results. An important step forward in **Chinese-Hungarian financial relations** was the participation of the Banking Association's Secretary General in the Boao Forum, and his signing of a letter of intent on the establishment of the Asian Financial Cooperation Association (AFCA) and a cooperation agreement between the two banking associations.

Global regulatory authorities will finalize their financial reforms, decided on in the wake of the crisis. Therefore, in addition to the usual monitoring activities, the Basel Committee revised its handbook for jurisdictional assessments within the framework of the Regulatory Consistency Assessment Programme. It published its revised capital requirements for market risk and consulted on the review of the operational risk capital framework, on the review of the internal ratings-based approach (IRB) (more specifically, on reducing model variations), as well as on the review of Pillar 3 and the disclosure framework. The Financial Stability Board will dedicate extra attention to managing the new and emerging vulnerabilities in the financial system, including potential financial stability risks associated with market-based finance, bad conduct, correspondent banking and climate change.

The **European Union** will continue working on strengthening the economic and monetary union. The priorities set in the work program for the Dutch EU presidency in the first half of 2016 were: strengthening the banking union; creating and developing the capital markets union; strengthening and streamlining the political coordination of the European Semester; and supporting the combat against tax fraud and tax evasion. In January the European Commission officially launched the REFIT Platform, which had been announced as part of the Better Regulation Agenda in the spring of 2015. The most important discussions about the banking union concerned the ECB regulation on the exercise of options and discretions, creating the single resolution framework, and establishing the European Deposit Insurance Scheme (EDIS). The Commission is dedicating special attention to the creation of the Capital Markets Union. For this, it initiated a public consultation on the regulatory

framework of financial services and on the efficient regulation of insolvency. At the beginning of the year, debates on the proposal on simple, transparent and standardized securitization (STS) continued.

II. Macroeconomic outlook, the banking sector's operating criteria

In Q1 of 2016 the **world economic** outlook weakened in terms of growth for both developed and developing countries. In April, the IMF lowered expectations compared to January for developed economies in 2016: for the United States from 2.6% to 2.4%, for the Eurozone from 1.7% to 1.5% and from 1.0% to 0.5% for Japan. With regard to developing countries, the IMF did not lower expectations for China and India (it expects a 6.5% and 7.5% growth, respectively), however it forecasts a significant drop for Russia and Brazil: 1.8% and 3.8%, respectively. The slowing of world economic growth along with FED raising interest rates by 0.25% and foreshadowing a cycle of increased interest rates caused significant market turbulences in stock markets in January 2016. Stock market indices and raw material prices greatly decreased. In February, however, there was a turnaround in the general mood of investors. This was probably due to the fact that leading central banks, which had sensed the stock market turbulences and weakening economic indicators, made statements about monetary easing and took according measures.

Economic growth in the **United States** continues to be fueled by growth in the labor market and through it, high domestic demand. Export still cannot support growth, yet it seems that the decrease in investments has come to halt in Q1 and there is a slight increase in government spending (although this may be due to this year's presidential elections). While after it raised interest rates in December FED foreshadowed four other interest rate increase possibilities for 2016, statements published in Q1 were less and less strict in tone. The macro data that was revealed paints a mixed picture in terms of economic outlook: though employment grew at a favorable rate, other indicators (such as industrial production, inflation data or real estate market data) have moved in an unfavorable direction. Furthermore, the newest GDP estimates forecast an around 0% growth for Q1, which not only does not indicate the further increase of interest rates, but also raises the question of monetary easing. With all of this in mind, markets continued to price-out the probability of further increases in the interest rate. By now, they grant a less than 50% chance of an increase in interest rate before December 2016.

The growth trend of previous years continued in the **European Union**, Q1 also saw moderate GDP growth. However external and internal growth risks both increased, due to the slowing of the Chinese economy and the short-term unfavorable effects of immigration and investment concerns about growth decline resulting from a possible Brexit. In March, the ECB introduced further monetary easing measures: it decreased all three elements of the interest rate corridor; the indicative refinancing ratio (to 0%), deposit interest (to -0.4%), and credit interest (to 0.25%). In addition to decreasing interest rates, the ECB increased the quantity of acquisition of assets by EUR 20 billion (from EUR 60 to 80 billion) and extended the program to holdings in companies. Furthermore, it introduced measures to incentivize lending, through which banks that increase their loans granted to households and corporations at an adequate rate can gain access to discount refinancing credit.

In January the **Japanese** central bank introduced further monetary easing measures and the Quantitative and Qualitative Easing Program. Within this easing package, Bank of Japan decreased the deposit rate of certain banks to the negatives, -0.1%. In addition to interest rate reduction, the central bank of Japan increased the general expiry of government bonds bought during asset acquisition. As a result of these measures, Japanese government bond yields dropped to a record low: all bonds that expire within the ten years have negative interest on the secondary market. The yen strengthened compared to the dollar, despite the announced easing; therefore it is probable that the Japanese central bank will be forced to take other steps in order to boost the economy and to reach its target inflation level.

The **Chinese economy** continued to slow down. Due to central bank measures, the Chinese currency – in accordance with government desires and despite an increasing withdrawal of capital – stayed relatively stable compared to the dollar. However, this meant an appreciation compared to other important foreign currencies, and had a negative influence on export. The extreme indebtedness of Chinese corporations and their declining creditworthiness poses a significant risk and influences monetary policy. Authorities envision that banks will ease this through the exchange of larger credit ownerships and the securitization of non-performing loans.

Russia is still in recession. Although crude oil prices have somewhat increased (in Q1 they reached \$50/barrel instead of last year's average price of \$35), despite earlier consolidation efforts, this correction was still not enough to balance out the Russian budget.

The measured current **inflation** is 0.9% in the United States, 0% in the Eurozone and 0.3% in Japan. It is less than targeted in all three regions. Low **crude oil prices** contribute greatly to low inflation. At the beginning of the year crude oil prices reached a record low of \$30/barrel, then later increased to \$50/barrel. The reason behind these low prices may be on the one hand supply factors (American shale oil, the Iranian embargo has been lifted, new Saudi Arabian strategy), on the other hand weak world market demand. Petroleum reserves are stocked as high as ever. OPEC member countries and Russia have not yet come to an agreement on freezing production levels. The prices of crude oil may have a significant influence on monetary policy: unchanged oil prices may give way to further central bank stimuli.

There was a significant lapse in the **Hungarian economy's growth** at the end of Q1. On a quarterly basis, the GDP dropped by 0.8%, while on a year-on-year basis, growth is only 0.9%. In terms of a yearly rate, with the exception of Greece, out of all the EU member countries, Hungary's growth indicator is the lowest. On the production side, poor performance was due to a drop in *industrial production, mainly in the construction industry (-30%)*. The former is probably a powerful result of the vehicle industry's reduced production due to exaggerated concentration (and is predicted to be temporary), while the latter is caused by a significant slowing in the inflow of EU investment funds. During this quarter, there was no perceptible growth in *net export* either. At the same time, *labor market indicators* improved and gross incomes grew considerably, which, together with low inflation may further strengthen domestic demand.

By the end of the quarter the **consumer price index** once again sank into the negatives on a year-on-year basis, due mainly to the decrease in fuel prices. During the quarter, however, prices increased by an average of 0.3%, and core inflation remained stable (at 1.3%).

Balance indicators also paint a diverse picture. The central government deficit was HUF 125.8 million, which is only 16.5% of the appropriation for the year (data from one year ago showed HUF 536.7 billion, 44%). In contrast, the GDP-proportionated government deficit increased from 75.3% to 76.9%. Only 32% of the budget deficit is foreign exchange debt and the domestically owned share of the portfolio continued to increase. The external financing capacity of the country is extraordinarily high: 9% of the GDP, almost all sectors of the Hungarian economy save up and decrease their debts. In March, the central bank decreased the **reference rate** by 0.15 basis points, to 1.20% (the base rate is currently 0.9%). The single day deposit rate decreased to -0.05% percent, while the single day credit rate decreased to 1.45 percent (they are currently -0.05% and 1.15%, respectively). Decreasing the interest rate did not weaken the forint's exchange rate. The untold goal of MNB is to achieve profit on the balance sheet and to aid export through a relatively weak forint (with an exchange rate of HUF 310-320 per Euro), and to thus boost the economy.

In Q1, the **balance sheet total of credit institutions** increased very moderately, by 0.7% in nominal terms (by HUF 242 billion), and reached a little over HUF 33 trillion. In addition to the portfolio

growth in euros (the moderate strengthening of the euro), there was a significant decrease in forint assets. The two together had an almost neutral effect of the balance sheet total.

Within the **asset portfolio**, a favorable change was that growth in the credit portfolio strengthened (*net loan portfolio* grew by 6% i.e. HUF 916 billion), while within *liquid assets* the restructuring from central bank deposits (-32%, HUF 1.368 billion) to state securities (+11.7%, HUF 740 billion) supported by MNB's self-financing program continued. An interesting phenomenon is that while adapting to the introduction of the mortgage funding adequacy ratio in April 2017 would require the gradual buildup of mortgage bond portfolio, it decreased by nearly 10% in the first quarter.

The total **gross loan portfolio** increased by 5% (HUF 852 billion) in nominal terms. 55% of growth is EUR denominated and 45% is HUF denominated. In Q1 there was a unique change in the internal structure of the loan portfolio. 62% of growth (HUF 524 billion) was placed at domestic and foreign monetary institutions, alongside the moderate decrease of corporate and retail loan portfolio, 1% (HUF 58 billion) and 1.5% (HUF 87 billion), respectively. Foreign corporate loan portfolio (from outside the EU) grew considerably, by 33.5% (HUF 386 billion).

Impairment portfolio continued to decrease both for corporate and retail loans, by a total of 3.9% (HUF 63 billion).

On the **liability side**, deposit balances shrank by 2.2% (HUF 368 billion). This is due to the fact that aside from the public sector deposit portfolios decreased in all other important segments. In the case of non-monetary financial organizations the relapse was almost 10%, and it was nearly 6% in the corporate segment. The latter may, however, also indicate a favorable tendency, if the use of liabilities was aimed at investment. As for retail deposits, a moderately timed 1.9% shrinking can be observed. The combined decrease in deposits for the above sector reached HUF 650 billion, which was only partially compensated for by the nearly HUF 300 million increase in government deposits. *Interbank liabilities* grew by a considerable 6.6% (HUF 596 billion). It was a favorable turn of events that short-term deposits were replaced by long-term deposits (from mainly outside the EU) and interbank loans with a long-term maturity. Parallel to this growth, the portfolio of securities issued by credit institutions decreased by 7.5% (HUF 231 billion) – this was, in half, due to the previously mentioned decrease in mortgage bonds.

As an overall result of the above effects, by the end of Q1 the *net loan-to-deposit ratio* of the credit institutions sector increased to 94% (from 87% at the end of the year).

In terms of **profit**, business-related revenues (interest, fee and commission, and financial operation revenues) were more favorable than at the same time last year. The unfavorable tendency of profit on interest continued: in an environment with decreasing interest, interest revenues related to lending decreased more than interest expenses. At the same time the improvement in profit caused by the net gain on interest-bearing securities and derivative transactions exceeded this negative tendency. The comparability of other and extraordinary items is considerably limited by one-time effects due to the release of provisions for the settlement and HUF conversion of retail loans.

In Q1 of 2016, **profit before taxes** was outstanding compared to the previous period: it reached HUF 198 billion (HUF 124 billion more than at the same time a year before). In addition to the above mentioned improvement in business profit (a growth of HUF 96 billion total out of which HUF 32 billion is growth in the profit on dividends of subsidiaries), the decreasing impairment portfolio of improving lending stock, the sum of impairment accounted for foreign investment (HUF 34 billion, which exceeds the former), and the effect of settlement and HUF conversion that was carried over to this quarter together played the most significant role in determining profit.

As a result of these effects, the sector's annualized average return on assets, before taxation (ROA) was +2.4%, and its return on equity (ROE) was 25.5%, similar to the best performing years preceding

the economic crisis. However, among the factors influencing these results, there are significant effects that will impair profit by the end of the year, as well as downside risks. (The most important of these are the risks of derivative assets behind net interest revenue and the fact that the dividend revenue was only a one-time effect, which will decrease profit during the year, as well as the phasing out of the effects of settlement and HUF conversion.)

III. Corporate lending

According to the MNB's lending report in February:

"In the fourth quarter of 2015, credit institutions' outstanding loans to enterprises decreased by HUF 50 billion as a result of transactions. In an annual comparison, the portfolio's growth rate fell 6.7 per cent as a result of several one-off transactions which occurred during the year and the base effect. These include transactions by large enterprises which occurred in earlier periods as well as the volumes of portfolio cleaning performed by banks at the end of 2015. After making adjustments for the aforementioned transactions, which are not related to the underlying processes, the annual rate of portfolio contraction was 2 per cent. The dual trend based on corporate size is still characteristic; in contrast to the decrease in the total portfolio, the outstanding borrowing of the SME sector increased by 3.6 per cent in annual terms. Before the end of the second phase of the Funding for Growth Scheme, enterprises concluded new contracts for an exceptionally high value, i.e. HUF 338 billion. Thus, together with the FGS+ contracts, in this phase of the scheme contracts were concluded for a total amount of HUF 1,425 billion." Out of the contract portfolio signed in the program by the end of the year, nearly HUF 180 billion will be disbursed in 2016.

"Based on the banks' answers to the Lending Survey, the terms of corporate loans were eased further during the quarter, and this may be followed by additional easing in the next half year. While demand for short-term loans did not change, demand for long-term loans continued to increase and banks anticipate further growth in demand in both product groups in the next half-year. The financing costs of newly contracted corporate loans decreased further in the period under review."

The results of the Market-based Lending Scheme's interest rate swap conditional on lending activity (LIRS)

The central bank of Hungary (MNB) launched the Market-based Lending Scheme (MLS) in January 2016 to strengthen economic growth through SME lending and to shift to market-based SME lending. MNB created the program's more detailed rules with consideration of the consultations held with the Hungarian Banking Association. The main instrument of the MLS will be the interest rate swap conditional on lending activity (LIRS), which will aid participating partner credit institutions' interest rate risk management. LIRS transactions will have a maturity of three years and by participating in the tenders, credit institutions undertake to increase their SME loan portfolio by 25% of LIRS transactions each calendar year, during the term of the transaction.

In addition to outstanding demand for the five announced LIRS tenders, a total of HUF 780 billion was allocated by the Monetary Council out of the HUF 1,000 billion budget that was approved for the entire program. Due to the conditions of the instrument, the 17 credit institutions participating in the program undertook credit growth of nearly HUF 200 billion. According to the MNB, in 2016 this will mean a 5% growth in SME loan portfolio.

Within the framework of the Growth Supporting Programme, the FGS's third phase (the phase-out) will also incentivize the growth of credit portfolio. MNB will check lending performance for 2016 for the first time in early 2017. The MLS may also contribute to SME lending in 2017 and 2018 if credit institutions do not close their current LIRS transactions.

To complement the MLS, MNB provides the possibility of bank liquidity management supportive, preferential deposits to those active banks, which undertake to boost market lending. Credit institutions participating in LIRS transactions are granted the possibility of preferential, discount deposits with an interest rate set at the base rate in the sum of 50% of the LIRS' total value, at a monthly average.

IV. Lending to households

In the fourth quarter of 2015, the outstanding loans of credit institutions to households declined by about HUF 111 billion as a result of disbursements and repayments, and the conversion of personal and car purchase FX-loans. Outstanding forint loans decreased by HUF 82 billion, while total foreign currency loans fell by HUF 7 billion; in addition, the settlement of the exchange rate allowance related to the FX-conversion, in the total amount of HUF 22 billion, also contributed to transaction-based decline. In annual terms, outstanding loans decreased by 15.1 per cent by the end of 2015. Excluding the impact of the settlements and FX-conversion carried out during 2015, the annual rate of portfolio contraction would be 4.5 per cent. In the period under review, the volume of new loan contracts of the credit institution sector amounted to HUF 187 billion in total, representing an increase of 27 per cent in year-on-year terms. Based on banks' responses to the Lending Survey, conditions on housing loans remained generally unchanged in Q4, while the conditions on consumer loans were eased. However, the banks indicated that in the next half year no major easing of credit terms and conditions is expected in any of the segments. About half of the respondents reported a pick-up in demand for housing loans, while looking ahead almost all banks anticipate an expansion in demand. The APR and the interest rate spread on new, fixed-rate housing loans decreased, while those of the variable-rate loans increased.

New amendments in the regulation of the Family Housing Allowance Scheme (CSOK) – consultations with the Ministry for National Economy

- Although it was a formal amendment, the fact that the set of rules earlier incorporated in four regulations was redrafted in two separate regulations, for new and second-hand apartments, providing significantly a better overview for both practitioners and clients, had the effect however of a material one
- For new apartments, the price cap on the apartments that can be purchased was removed; the person receiving the allowance is allowed to keep their previous property and it is not compulsory to use the revenue from a property sold within five years to purchase the new property. Cohabitees and single parents received further allowances in the access to the subsidized loans.
- For second-hand apartments, among others, the amount of the state grant grew further, and only a lower floorspace threshold is prescribed for the apartment to be purchased (the price cap is removed).

The Banking Association organized several consultations to facilitate better manageability of those changes materially affecting mortgage lending:

- the Secretary of State in charge in the Ministry for National Economy provided information and a consultation opportunity, while
- experts from banks could discuss the details of the regulatory amendments with the officials in the competent department of the Ministry for National Economy.

In this latter case, the Banking Association helped in the efficiency of this consultation by collecting questions in advance, and prepared a memo containing all questions and answers dealt with at the

meeting, and discussed with an official from the Ministry for National Economy before circulating it to the banks.

Numerous issues were clarified covering several topics (such as the eligibility of loft constructions, assessment of the realistic chance of having children and the set of terms and conditions for property insurance); however, due to the complexity of this issue, numerous problems persist, and the government sought to settle them by issuing guidelines and amendments to the regulations later on.

Consultation on the interpretation of domestic legislation transposing the Mortgage Credit Directive

Following the publication of the consumer lending acts and implementation decrees transposing the EU legislation in late 2015 and early 2016, our members highlighted that it would be important to clarify with the responsible Ministry the interpretation issues raised before the application of these laws in March. We received guidelines from the Ministry for National Economy in the merit before the end-March application date of these laws, but the required changes to the laws and decrees can only take place later on.

During this consultation process we successfully ensured that

- employees responsible for the examination of creditworthiness and involved in the loan decision are not excluded from the incentive opportunities (they can be granted bonuses, for example, based on the number of customers they deal with or for their faultless work, but their remuneration cannot depend on the number and proportion of accepted loan applications),
- the regulations that made the complicated and pricey conversion rules, initially applicable to FX loans, mandatory for initially HUF loans are amended,
- specialized credit institutions not entitled to keep accounts can require their debtors to open a free account for loan service, although with other banks,
- the authority interprets the mortgage agency activity, appearing as re-regulated service, if the agent operates in this capacity as a tied agent, and in other capacities (such as car loan agency) as an independent agent,
- the legislator clarified that the new commission cap (2%) introduced for loan agents applies only to contracts concluded after the entry into force of the legislation.

Queries from banks on the interpretation of the legislation concerned keep coming in.

V. Further important regulatory events influencing the operations of the banking sector

Preparation for the amendment of the Civil Code, the loan collateral register and the related legislation

In the context of preparing for the amendments to the Civil Code, we participated in several meetings with the banks' legal experts, including a series of public debates organized by the Law Association of the Ministry of Justice. Together with the managers and experts from the Ministry of Justice, we reviewed the regulatory proposals for financial contracts (payment account agreements, leasing and factoring agreements). Before distributing them to the Ministries, we made an itemized proposal for the text of the legislation, supported by reasoning; we made a detailed observation to the version distributed to the Ministries for consultation.

For various reasons, only a significantly reduced part of the amendment proposal was submitted to the Parliament. According to the submitted proposal, the regulations on the senior officers of legal

entities, as well as the regulations on lien and security deposits will be amended. In the latter context, the concept of individual lien will be reintegrated to the Civil Code. The Chapter in the Civil Code on securities will have a new text, with a view to aligning the Capital Market Act and the Civil Code. At the same time, the open concept of securities will be maintained, thus providing opportunity for capital market innovation. The invalidity of fiduciary collateral will be maintained in the context of consumer transactions. Under the changed rules on contract transfer, the security for the performance of obligations will be maintained unless the obligor of the collateral fails to grant consent to the transfer of the contract.

In order to reintegrate individual liens, we made further legislative proposals, based on feedback from mortgage banks.

In the context of preparing for the amendments to the Civil Code, we addressed in detail the issue of the amendments to the loan collateral register regulations. In the legal working group, we organized a separate consultation, to which we invited the experts from the Hungarian Chamber of Public Notaries (MOKK) working on developing the new regulations, and we made specific proposals for the data content of the new register. The essence of this amendment is to bring back the authentic nature of this register, and the principle of registration based on official documents. This register would record liens on unregistered movables, vehicles, unregistered rights and claims and, as an innovation, recordable data and security declarations set out in separate legislation.

According to experts, the draft law is not sufficiently mature and contains contradictions, and we made numerous specific observations regarding it and proposed a thorough redrafting of the proposal. Finally, the draft law on the Loan Collateral Register did not make its way to the Government, and also the proposal for the amendment of the Civil Code as submitted to the Parliament fails to deal with issues directly related to the Law on the Loan Collateral Register (leasing, factoring.)

Amendments to the Act on Enforcement (codification work group)

In January 2016, the administrative secretary of state to the Ministry of Justice initiated the establishment of a codification work group to review Act LIII of 1994 on Court Enforcement. In this codification committee, apart from the senior officials and experts from the Ministry of Justice, the Chamber of Bailiffs, the Chamber of Hungarian Public Notaries, MAKISZ (professional organization of debt managers), the National Court Office, the MNB, and MARK Zrt. also participated, and the Banking Association is represented via several legal professionals active in the enforcement area. This codification committee holds its meetings every three weeks; according to the schedule we review law enforcement issues related to individual chapters of the Enforcement Act. We did not receive any preliminary written concepts from the Ministry; at managerial level it has been declared that issues related to the status of bailiffs and organizational matters will not be dealt with in this law, since they consider them resolved by the 2015 amendment. The main purpose of this amendment is to consolidate the text of the law, which is rather fragmented due to the numerous amendments, and to codify the methodological solutions and results achieved by the case law.

This draft law is planned to be submitted to the autumn session. In order to make our participation in the committee efficient, we had a joint meeting with the delegated law professionals from the Hungarian Bailiffs' Chamber and MAKISZ, which proved to be rather useful. (In our meetings with the managers of the Bailiffs' Chamber, we also reviewed the issue of enforcement procedures restarting after the expiry of the enforcement moratorium, issues related to bailiff notification after the settlement process and other experience related to the operations of bailiffs.)

The working committee so far dealt with three chapters out of 23 chapters of the Enforcement Act. We sent several written proposals to the Ministry on the topics dealt with so far. We raised the re-

codification of the concept of preliminary procedure applied earlier and we made a detailed proposal for it.

Consultations with the Ministry of Justice and requests for positions in connection with the amendment of the act on personal insolvency; consultation on the order on the sale of assets

Act CV of 2015 on the Debt Resolution of Private Individuals was amended twice after its adoption, but also the need for a comprehensive review occurred, for which purpose we had several consultations with the Ministry of Justice. Earlier this year we submitted our proposals to the Ministry of Justice in a 40 page paper with tables, then in February/March we provided our opinion on the lengthy legislative package prepared by the Ministry of Justice. We proposed a radical reduction in the application documentation and to regulate a simplified debt settlement process, together with numerous proposed amendments not included in the initial draft. We did not support the increase of the income limit exempted from the creditors' claims, due to subsistence costs, since this would compromise the effectiveness of the procedures. This law was amended in April, but only the time limit for the application for the procedure was extended, until 30 September 2016. The submission of a lengthier proposal was postponed to the second half of 2016, in view of more urgent draft laws. At the initiative of our members, we have requested individual positions on several issues from the Ministry.

We have provided opinions in several rounds on the draft Government Decree on determining the market value of the debtor's assets related to the debt settlement procedure for private individuals. The sale of the debtor's assets as set out by the law must be performed at arm's length, in a public and transparent manner; for precious movables and immovable property, this means the use of the online electronic auctioning system (EAR) operated by MNV Zrt. In the court debt settlement procedure, the tasks of the seller are performed by the family administrator appointed for the family. In our observations, we made proposals to make the procedure more market-based, and we made some proposals to protect the interests of creditors. As such, we initiated the following:

- not to exclude creditors from the procedure,
- the sale should not be less advantageous for creditors than a sale under the Enforcement Act,
- bids in the first round should not be restricted to buyers subject to personal insolvency.

Providing opinion on the amendment to the Civil Procedure; electronic liaison with courts

In the amendment to Act III of 1952 on the Civil Procedure at the end of 2015, the introduction of mandatory electronic liaison with courts was postponed to 1 July 2016. The Banking Association was also amongst the institutions that initiated the introduction of a company gateway for the company and legal representatives of economic actors established in Hungary for liaising with the courts, based on the example of official gateways, rather than using their own personal gateways for this purpose, thus providing access to several employees and representatives of the economic actor. In our observation made to draft No. T/10308 on the Amendments to the Civil Procedure, we made proposals to solve the practical and technical issues related to the launch in July. In addition, to assist our members in the preparation, with the members of the ad hoc working group we initiated a consultation with the Electronic Procedures Department of the National Court Office and the E-Administration Department of the Ministry of Internal Affairs. Experts from the Ministry of Internal Affairs and the National IT Services Ltd provided information on the newly developed system to the legal work group. We successfully ensured that interested bank experts could voluntarily participate in the system testing.

Moneyval evaluations

Based on the new recommendations and methodology of the FATF (Financial Action Task Force), the Committee of Experts on the Evaluation of Anti-Money Laundering Measures and the Financing of Terrorism (Moneyval) of the Council of Europe began its fifth round of country evaluations in 2014. The primary aim of these Moneyval coordinated country evaluations is to assess the implementation and enforcement of international standards to counter money laundering and the financing of terrorism by covering legislation, institutions and market actors as well. In addition to evaluating compliance with standards and norms (legislation and institutional background), efficiency and effectiveness will also be a priority.

Hungary is third on the list of countries to be assessed. Its evaluation will probably end by late 2016, with the acceptance of the report on the country. The Ministry for National Economy was the main institution responsible for the professional coordination of the country's evaluation. The so-called "on-site visit" took place between March 7th and March 18th in Budapest. The 9 delegates of Moneyval met with the institutions involved in the battle against money laundering and terrorist financing, and with the authorities concerned as well as the representatives of service providers and advocacy associations falling under legislation regarding money laundering and terrorist financing. The HBA compiled a written summary of its anti-money laundering activities, which was given to the representatives of Moneyval after their meeting.

Using the e-ID

In January 2016, the Central Office for Administrative and Electronic Public Services (KEKKH) contacted the Banking Association to help organize the information and training of bank employees on the introduction of the electronic ID cards. On February 1, 2016 the representatives of the Banking Association, KEKKH and IdomSoft Zrt. (the company responsible for the technical realization of the e-ID) held a consultation, with the following results:

- On February 18, 2016 the representatives of the Ministry of Interior and the developer company held an informative presentation (over two hours long) during which they also answered the questions posed by banking experts.
- Since professional questions in connection with the e-ID may concern several other fields of specialty, the Banking Association will organize consultations for relevant authorities and working groups in the future. The bank security working committee gathered its preliminary questions concerning e-ID security.
- KEKKH compiled a written information packet, which includes issues on the practical use of the e-ID. We made this available to all member organizations. Furthermore, we evaluated the need for the training of administrators, since KEKKH offered to organize the training of colleagues who hold administrative training on certificates and their examination within financial institutions.

The consultation with the bank security working committee is currently being organized. KEKKH is also currently organizing the training for administrators.

VI. Developments regarding the central bank of Hungary

MNB Recommendation on the restitution of retail mortgage loans affected by late payment

In March 2016, and in essence without preliminary consultation, the MNB issued its *Recommendation on the restitution of retail mortgage loans affected by late payments*. This Recommendation provides for the completion of an extremely complicated, time-consuming and

costly procedure by the creditor in order to restore the solvency of the debtor, before terminating the defaulted loan or, for already terminated loans, before selling that loan. The ultimate goal of this is to develop a long-term payment solution, together with the customer, and for this purpose the creditor must use all available means to enforce cooperation (numerous notifications via phone/letters, extraordinary information requests, means assessment).

The MNB considered issuing this Recommendation as a priority since

- the c. 140,000 non-paying customers pose a huge macro-prudential risk for the banks, and a social risk for the country that is hard to solve,
- the conversion to HUF/settlement process is completed, creating a clear picture of the debtors' situation,
- the termination of the eviction ban can create new incentives for debtors' willingness to pay.

–The Banking Association sent a detailed written observation with regard to both the conceptual basis and the actual text of this Recommendation to the MNB, also confirmed orally at a managerial consultation. Experts from the member banks could clarify the issues related to this Recommendation in the context of consultation organized jointly with the MNB. At these fora, we strongly object to the issue of this Recommendation since

- the relevant customer base was contacted by the banks on numerous occasions, offering repayment easement, but mainly without success, for social reasons. This will not be changed by a complicated, costly and lengthy campaign encouraged by the authority,
- its legal background is unfounded; the affected consumer fundamental rights must be regulated in laws (Civil Code, Credit Institution Act), while making the termination of the claim and selling the terminated claim conditional violates the banks' fundamental rights,
- assistance to the non-paying customer base might undermine willingness to pay among performing customers.

During the short preliminary consultation, only a few of our numerous amendments and ideas were adopted. Implementing this Recommendation required significant resources from the banks; at the same time it is doubtful whether it brings any actual progress in handling the situation of non-performing customers and so it is justified to restrict the customer base subject to the Recommendation. In view of the above, the Presidency considered it necessary to initiate consultations with the top management of the Supervisor.

EBRD and MNB project for developing the principles regarding the settlement of non-performing corporate loans outside the courtroom

In late 2014, the EBRD and MNB started a shared project to explore the legal, regulatory and interest issues that pose as obstacles to the management of non-performing corporate loans. The result of this was a 92-page study that includes the essential problems and recommended measures to be taken, and which was presented to the professional public in March, 2015. Most of the study's recommendations involved initiatives for new legislation, however they also brought up the need to review the "Budapest principles" – the settlement of non-performing corporate loans outside of court, which involves several banks and was designed within the Banking Association's framework in 2010.

The EBRD and MNB organized a consultation in the second half of January on the management of non-performing corporate loans. Their goal was to promote the integration of debt settlement outside of court into banking practice through the review of the Budapest principles or the creation of

a new voluntary regulatory system. During the consultation the EBRD presented the results and effects of similar projects it helped coordinate in other Central Easter European countries. EBRD organized the Hungarian project to handle this problem. A consultation with the most affected banks and the Banking Association was initiated by Ernst & Young, the consultant hired by the EBRD. The preliminary recommendations of the consultant were: the elaboration of more detailed principles for cooperation, and the creation of a more flexible standard document package to support the processes.

Developments regarding the payment-to-income ratio (PTI)

MNB, after the consultations to fine-tune the PTI ratio in August and November, 2015 also held consultations in the second half of January, 2016. At these, they clarified interpretation issues with experts from banks and the Banking Association, which we had notified them about before, and which arose during previous consultations.

In light of the ECB opinion on regulatory amendment, the MNB also called market actors to consult at the beginning of March. At the consultation it showed that according to the ECB, the 60% PTI ratio needs to present an actual limit relating to the *full installment burden*, even if only 85% of the installment of loans with an interest period of longer than 5 years is considered when calculating the ratio. In practice, this results in favorable use being only enforceable for an income of less than HUF 400,000.

There were further problems with the planning of the relevant *Frequently Asked Questions (FAQ)* in February; therefore, the final FAQ will be published in early April. The MNB had the modified decree enter into force on May 1st.

Developments related to the Mortgage Financing Adequacy Ratio (MFAR): position of the Ministry for National Economy on the establishment of securitization rules and MNB consultation regarding the launch of the MFAR

At the end of January, the Banking Association contacted the competent regulatory department of the Ministry for National Economy in the context of implementing the securitization rules in Hungary in line with Article 129 of the CRR. The MNE informed us that the EU Commission has initiated a regulation in the context of the Capital Market Union, the outcome of which is to be expected by the autumn. Before this they do not intend to deal with this issue, i.e. they will not establish the legal terms of debt securitization.

The MNB convened a consultation at the end of February for the retail and mortgage banks concerned, in order to review the legislative amendment process regarding the launch of the MFAR indicator and the state of play of the implementation by the banks. At the request of the MNB, we collected the observations from our members in advance, and, in the framework of our cooperation, we integrated the opinion of the Association of Hungarian Mortgage Banks. At this consultation, it was reported that the mortgage bank foundations announced earlier are well under way; however, the pace of the legislative amendments lags behind what is required. The attending MNB experts agreed with the legislative amendment proposals made by market actors and declared their support for them at the other regulatory authorities (Ministry of Justice, Ministry for National Economy), but they suggested that banks also contact the Ministries directly.

The Banking Association sent its proposals related to the key amendments to the *Mortgage Bank Act* in early April to the competent Secretary of State at the MNE. In this letter we requested, to enable re-financing of the existing mortgage loan portfolios, the deletion from the law of the mandatory

inclusion of the obligation to tolerate the satisfaction of the mortgage bank claims in the public notary documents containing the unilateral undertakings of the debtor, as well as the expected inclusion of the ban on transfers and burdens. In addition, we made several additions to the text, and suggested additions to the bank secrecy protection rules in the Credit Institutions Act and appropriate treatment of separated mortgage rights in the accounting regulation of credit institutions. The MNE took our proposals into account when submitting the financial omnibus act at the end of April.

Consultation with the MNB on remuneration matters

In its 2015 December meeting, the Presidency invited the HR Committee to review the issues related to the official position developed during the supervisory examinations on remuneration issues and to consult the competent department within the MNB. In the mid-January consultation, the HR Committee established that the main issues are

- the interpretation of the publication obligation related to the individual remuneration data of senior officers,
- in connection with the reinterpretation of proportionality, exemptions from the deferred or non-monetary payment of the performance remuneration, and
- excessive expectations towards small institutions (in the tail).

The Committee identified further reporting-related and technical issues. We sent the Banking Association's position in a letter to the competent Deputy Governor of the MNB the week after this consultation, requesting a face-to-face consultation from the supervisory authority. The consultation with the supervisory branch of the MNB at executive director level took place in mid-February. In principle, the MNB supported the interpretation and proposals made by the Banking Association and declared that they do not expect individual reporting of individual management incomes. They have adopted our proposals linked to the application of the proportionality principle in line with the old practice, temporarily, pending the entry into force of the relevant EBA Recommendation in early April 2017 and the amendment of CRD IV as proposed by the EBA. The MNB intends to settle technical issues by issuing an MNB FAQ.

BUBOR

In the middle of February MNB started the modification of BUBOR quotes at a consultation, where BUBOR panels and potential panel banks also participated. The aim was to strengthen the market nature of the quotes through introducing transaction obligations. The original proposal of the central bank contained a bilateral price quotation (in addition to BUBOR, they suggested the introduction of BUBID). Transaction obligations would have applied to one-week, one-month and three-month maturities and BUBOR quoting would have been done as before, but following a mandatory 45-minute quoting period.

After having summarized the proposals of the banks concerned, the Steering Committee of ACI Hungary discussed its modified proposals at its March meeting. Based on the proposals made by banks and the Steering Committee, ACI Hungary returned to unilateral quoting, where acceptance of deposits is offered at a 15 basis point spread. Quoting is obligatory for 1 and 3 month maturities and is done at set rates after the BUBOR quoting. The new rules limit the sum and quantity of contracts that must be accepted. The modified rules have been integrated into ACI Hungary's BUBOR regulation and the latter was approved and sent to the banks concerned by the Steering Committee on the 1st of April. The amended regulation entered into force at the beginning of May.

Another significant development was that at its March meeting the Steering Committee discussed the obligations arising from the EU benchmark. It sent a letter to MNB afterwards, in which it offered

to hand over BUBOR's administrative tasks to the central bank. At the end of March, MNB said that it would be ready to take over these tasks if ACI Hungary handed them over along with all the relevant legislative rights. MNB also indicated that the soonest it could take over the tasks would be autumn, 2016.

ACI Hungary is considering setting the following preliminary conditions for handing over all rights:

- the use of BUBOR should remain free of charge;
- MNB undertakes that it will refrain from any modification of the current BUBOR regulation for a specified period;
- if MNB decides later that it does not wish to continue managing BUBOR administration, ACI Hungary will have the primary right to reclaim it;
- MNB should include ACI Hungary in professional issues at least to the extent of consultations.

It is the general assembly of ACI Hungary that must decide on this issue and they will probably do so in September 2016.

The Hungarian Restructuring and Debt Management Ltd (MARK) formally starts its activities

At the beginning of March the European Commission published its decision regarding the activities of MARK, based on which MARK may begin operating (under the aegis of MNB). As initiated by the central bank, we held a CEO consultation the next day, where MARK's CEO presented the conditions of MARK's operation and its timing. The debt management company started the process of acquiring bad portfolio on March 21st with a 3-month bank registration and portfolio offer period. When this period is over no other bad portfolio may be offered. After the registration period finishes in June, MARK will have one year to complete the entire process.

Discussion paper on debt management

The regulation of debt management activity is a long overdue deficit in our legal system. In recent years the Banking Association has raised its voice several times in favor of regulation by law. At the end of 2015, the Consumer Protection Directorate of the MNB initiated setting up an expert group to prepare the legislative concept for the debt management activity. The aim of this regulation was to establish the organizational and operational framework for collection of past due consumer debts by credit institutions. In January, following a multi-round detailed consultation with retail workout experts, we sent a detailed proposal to the MNB for the themes of the regulatory concept and appointed members to the expert group. We supported restricting the scope of the law to consumer debts arising from financial services; furthermore, we made proposals on the personal and objective conditions for licensing this activity and the sanctions for unlicensed activity.

We have carried out separate consultation on this concept with the experts from financial firms (PVOE) and debt managers (MAKISZ).

Due to other legislative tasks, the regulation of debt management has been postponed.

Changes in the 2017 MNB reporting due to the transition to IFRS - activity of the joint working group with the MNB

At the beginning of 2016, the joint working group with the MNB continued consultations on the 2017 reporting requirements related to the transition to IFRS. The central bank presented its plans in connection with ordering *new reporting, detailing the statistical balance sheet, Profit/Loss Account and balance sheet details* (regarding 2016 end December and 2017 opening data), to be completed by all credit institutions. The MNB decided that the 2016 end December stocks of the statistical

balance sheet have to be reported with the deadline of 1 February 2017, in order to enable the clarification of issues raised by the expected breaks in the time series before the receipt of the January 2017 data. Credit institutions migrating to IFRS as of 2018 must continue to submit the current supervisory balance sheet and P/L tables in 2017.

The new *individual FINREP* opening reporting package for 31 December 2016 will be extended by the MNB (compared to the preliminary version) with “Financial liabilities per product and customer sector” and performing and non-performing exposures and restructured exposures data, split by HUF and FX.

Central bank experts confirmed, based on consultations with users within the MNB, that no material changes can be expected in the *daily reporting* (D01, 4LAN, CASHFLOW) due to migration to IFRS. If specific issues are raised, the MNB is open for consultations on the daily reporting. Daily reporting will be published in the autumn reporting decree rather than in the spring one.

Numerous observations from the Banking Association were integrated in the *draft MNB decree on reporting obligations on credit institutions’ certain financial instruments, financial information and capital adequacy*, on which a public consultation was launched at the end of February. Due to the change related to the IFRS migration and in order to allow for a longer preparation time in this context, the MNB intends to issue the final reporting decree a lot earlier than usual, already in May 2016.

VII. Payments

Managing direct debit after the switch between gas and electricity service providers

After the government decision was made to appoint new gas and electricity service providers, it became crucial to change the regulation on direct debit, which ensured payment. It also became necessary to organize the transfer of client data needed for direct debit authorization modification from the old service provider to the payor’s bank. The legislation which makes authorization transfer possible and the schedule that organizes interbank data flow (coordinated by the Banking Association) was already completed at the end of last year, however they were only implemented in the first two months of 2016 (electricity in January and gas in February). Successful tests predicted a problem free transfer. Both the service providers and the banks holding their accounts followed this strict schedule, and thus the mass transfer of hundreds of thousands of clients was completed without virtually any problems, and with minimal manual interference. The universal gas provider asked the Banking Association to organize the direct debit part of its next acquisition (TIGÁZ clientele), which we perceived as positive recognition of our organizational work.

Bank Cards

- *Implementing the EU regulation on MIF*

Regulation EU 2015/751, adopted by the European Parliament and the Council last April presented the European banking sector with many administrative tasks, in addition to the regulation of interchange fees. While the December 9, 2015 deadline defined the tasks (mainly for acquiring banks) through the introduction of “transparent” pricing, the second round of implementation on June 9, 2016 demands comprehensive preparation on the part of issuing banks. The EU regulation allows merchant partners to refuse certain types of cards during payment. As a result, issuers must

indicate the card's type (credit/debit/prepaid/commercial) on the card itself to inform merchants and consumers.

In order to meet the regulation's criteria, we consulted with both MNB and the card companies several times. During these consultations we managed to achieve that stricter Hungarian legislation will be harmonized with the EU regulation, and thus the termination of the IC regulation of commercial cards (temporary for now).

Due to the effect the EU regulation will have, with the P08 report MNB significantly expanded data service on bank card data and decreed that acquirer banks must to provide extraordinary data on the past 3 years. Five big banks indicated that they would have problems meeting the requirements of the decree, therefore we asked MNB for a deferral. MNB did not grant a general deferral, only a partial one in certain cases.

- *MNB consultations regarding the introduction of MasterCard Installment*

We initiated comprehensive preliminary professional consultations with MNB's Consumer Protection Directorate on the introduction of MasterCard's Installment (installment repayment service tied to credit/debit cards) product. The main goal of these meetings was to understand which type of consumer protection directives, proceedings MNB will apply to market actors in connection with the introduction of this product. The product is already available among international financial services. The practical experience of banks and card companies makes it possible to establish a constructive, solution-oriented dialogue with MNB experts. Three rounds of consultations were held, at the end of which MNB compiled the summary of the "minimum requirements" for the introduction and use of the product available to banks. The relevant deputy governor of MNB deemed it extraordinarily constructive that consultations between experts and regulators began before the product was introduced.

- *Information in connection with bank card fraud*

The first couple of months of 2016 passed very calmly concerning bank card security; with no special fraud cases. At the same time, several *calling card charge swindles* (executed through the use of bank cards) were committed. These did not present banks with fraud loss, but did cause clients to file complaints. We tried to limit the number of these frauds (several hundred per month) by warning clients and professional collaboration between banks.

Geoblocking has now reached Hungary as well through certain banks, "innovators" in fraud prevention. Geoblocking works by limiting card use geographically, based on the card holder's card use habits. This solution has been very successful in several parts of Europe and has led to a significant decrease in fraud damage.

Thanks to professional collaboration we were able to share with our member the comprehensive report compiled by Europol and Trend Micro on the logical attacks on ATMs in the past 5 years on the same day that it was published. The report includes descriptions, details and advice.

Together with MNB experts, the bank cards working group reviewed the part of the *recommendation on the security of internet payments which concerns bank cards*.

We continued the establishment of the *Cyber Crime Cabinet and Lab* with the MoI International Training Centre. The first international training will be held at the end of May, with police cyber experts from 24 EU countries taking part. Through their preparation they will contribute to the cross-border prevention of fraud.

Experience in connection with the introduction of the new 20,000 banknote

Virtually no problems have arisen since the new 20,000 bills were introduced in December, 2015 as part of a series of new banknotes. The replacement of the old banknotes is a gradual process. At the same time, the method of removal for the old bills led to a professional debate. The majority of banking professionals voted for a gradual switch, which allows recirculation and which would have the removal deadline postponed to the furthest possible date (even the end of 2016 if need be) – this is also justified by the significant cash amount necessitated by circulation. Based on data received from credit institutions, the central bank decided to accept the removal deadline proposed by banks (the end of the year), however, every cash market actor is obliged to refrain from recirculating the old 20,000 banknotes from May 2016.

The XML account statement

Straight Through Processing (STP) means the processing and management of payment order in the entire payments process, without the “touch” of human hands: a modern expectation, and therefore part of SEPA. The SEPA working committee’s *XML working group’s account statement* makes the fulfillment of this requirement possible in the case of transfers in forint. The account statement supplements and therefore completes the payment process. Until now two phases were possible for forint transfers, on an interbank voluntary basis as a legislative and client-bank requirement. On the other hand the account statement exceeds this in content, since it not only contains information on transfers, but also provides uniform statements (independent from the bank) for other operations for a given period.

The standard which was issued as part of a recommendation is the result of several years’ work on the part of the working group (with members from BB, CIB, Erste, MKB, OTP, Raiffeisen, UniCredit, GIRO and Generali and their suppliers). It was also supported by GIRO Zrt. The GEFEG software, which ensured the proper maintenance of the standards and its publication and which was granted to the working group also helped in creating these standards.

Preparing for the SEPA End-date Regulation

The SEPA working committee continued its activities as planned in connection with the SEPA End-date regulation¹ (adopted in 2015) as well as on payment service providers and the support of their clients. Thus, it completed and sent its letter on *payments bundles* to payment service providers, in which it also wished to provide information to the entrepreneurs concerned. In addition, a newspaper article was written in the subject in order to familiarize a wider audience with bundles.

The ECB will also follow the preparation of member states outside of the Eurozone through the European System of Central Banks, by asking for regular reports. In collaboration with MNB, the HBA compiled a *shared questionnaire*, which was answered by the members that it concerned. Responses showed that these banks typically launched their preparation projects by Q1 of 2016 the latest, and they informed clients involved in the instruction of bundles on necessary or possible solutions in the same period. In addition, based on the responses, it is probable that everyone will successfully complete the preparations on Euro payments, and will complete migration by October 31, 2016 the latest.

¹Regulation (EU) No 260/2012 of the European Parliament and of the Council of 14 March 2012 establishing technical and business requirements for credit transfers and direct debits in euro and amending Regulation (EC) No 924/2009 Text with EEA relevance

EU Forum of the national SEPA Committees

On 3 February, the eleventh and last meeting of the National SEPA Coordination Committees was held in Brussels. On the one hand, this meeting was linked to the 1 February 2016 expiry of the temporary exemptions from the final SEPA implementation date as set out in a Regulation, and on the other hand, to the requirements to be complied with by the non-Eurozone Member States by 31 October, as well as to the new virtual means of payment and the prompt payment system. The main findings of this Forum can be summarized as follows:

- the Eurozone SEPA transition is completed; however, deepening the cooperation in the areas of transfers and collection orders is needed,
- nearly all EU Member States are working on the implementation of prompt transfers,
- the European Commission treats the prevention of using prepaid cards and virtual or digital currencies for money laundering and financing of terrorism as a priority,
- it is expected that the transition of non-Eurozone Member States to the SEPA will be smooth,
- Hungary performs very well in the introduction of PayPass cards and card readers,
- Hungary's preparation for the 31 October 2016 transition deadline is underway; a smooth migration is expected.

Preparation for the launch of the EU Payment Services Directive (PSD2²): The related EBA discussion paper - opinion from the European Banking Federation

The Payment System Directive (PSD2), adopted by the EU but not yet launched, provided the European Banking Authority (EBA³) with a standard.

- on the customer identification methods resulting in a high degree of security,
- on the communication between parties participating in e-commerce.

On the basis of this authorization, the EBA launched a consultation on its discussion paper on the standards for liaising with third party service providers (TPP⁴), considered as key actors in e-commerce. This EBA discussion paper raised questions and issues, and expected answers to them from market actors, such as

- how a communication standard providing a high degree of security can be created without forcing any actors to make disproportionate developments,
- whether mobile phones, considered to be the foundation of customer contacts, are suitable, on their own, for storing unique identification data, on the one hand, and as a means for biometric identification (such as voice recognition) on the other hand, and third, for accepting a dynamic code (e.g. single use codes) via mobile networks. (Namely, the Directive provides that reliable customer identification must include at least two of these three available methods, and harm to one of them cannot result in the non-usability of the other)

In its reply the European Banking Federation highlighted, amongst other issues, that

- a governance body must be established in the EBA project, which develops and maintains (as a quasi model host) and deals with the registration of enrolments and dispute settlement between members,
- detailed listing of the standard types of various risks cannot be avoided, due to the numerous actors/technologies and message channels imposing various risks,

² Payment System Directive

³ European Banking Authority

⁴ Third Party Service Providers

- In the event of a dispute, the way to be chosen in any case is where the account issuing bank (which takes the highest risk), determines the required level of security.

Based on the market observations received, the EBA will redraft its discussion paper and launch a three month consultation on it.

The rapporteur from the Banking Association gave detailed information to the Payment Services work group on the PSD2-related work of the European Banking Federation.

VIII. Tax and accountancy

Industry proposals related to the local business tax and corporate tax rules in the context of the IFRS transition, other taxation matters

The taxation work group examined, out of the taxation rules applicable to credit institutions migrating to the application of IFRS in 2017, the requirement on local business tax and sent an amending proposal to the Ministry for National Economy, responsible for the preparation of this legislation. The essence of this proposal is, instead of the current rule that generates numerous questions in practice, to place the definition of *net revenue* on a basis that is easier for the industry to follow and apply. Industry experts share the view that, for this purpose, the EBA FINREP Profit/Loss Account structure is the most suitable; this will be part of the auditor's special report as of 2017, as data to be reported to the MNB on a quarterly basis and audited annually. To strengthen our proposal, we submitted comparative data under the 2014-2015 FINREP and under the currently effective rules (based on reports mainly from larger banks, already using IFRS on a consolidated basis). In addition, we contacted the experts from the Association of Investment Service Providers (BSZSZ), since the Ministry intends to maintain the joint definition of net revenues under the effective laws, applicable both to credit institutions and investment firms. BSZSZ supports the proposal of the Banking Association; however, the lack of a P/L table from the MNB to be used/required to start with by investment firms choosing the IFRS ~~is~~ problematic; we requested the MNB to prepare this table.

The group of banking experts started the examination of the *requirement to pay corporate tax based on IFRS* and uncovered several issues. On this basis, we requested to join the consultation between the Ministry and tax advisors, also justified by the fact that, for credit institutions, migration to IFRS is not an option but an unavoidable obligation.

In addition to this, we carried out consultations on the regulatory issues to be followed after the repeal of the *EU Savings Directive*: on the rules of establishing tax residency for foreign customers earlier subject to the Savings Directive and the rules for tax payment on interest income.

Expected change in the regulation of auditing with regard to institutions of public interest

A draft law on the amendment of Act LXXV of 2007 on the Hungarian Chamber of Auditors, on the activity of auditors and on the public supervision of auditors, as well as certain financial acts was submitted to the Parliament in March; this contains a much stricter rotation period for auditors than the one prescribed in the EU Directive 537/2014 (10 years rather than 5 years), and other guarantees in this regard (4 year ban on re-election, independence requirements related to auditing in the context of company transformations. All these together are too strict and mean a competitive disadvantage for institutions established in Hungary, including all credit institutions.

We highlighted this issue to the Ministry for National Economy, to the MNB and the Economic Committee of the Parliament, and requested their intervention to introduce a 10 year rotation

period, as applicable in most EU Member States. We argued that if different rotational periods apply within a group, several audit firms can be affected at the same time—and addressing diverging views arising during the audit (mainly in connection with risk assessment) may take a lot longer than currently. Audit methods and documentary requirements applied by audit firms can differ from firm to firm, and coordination within a group generates an unnecessary additional burden, both in administration and in costs. We consider the timing of the planned legislation also critical, since the year of auditor change will coincide for most economic actors of public interest with the mandatory transition to IFRS and, due to this, auditing will entail more tasks than usual and pose additional risks.

IX. Developments within the Banking Association

GVH proceedings in connection with BankAdat

On January 11, 2016, the Hungarian Competition Authority handed the Hungarian Banking Association and the Institute for Training and Consulting in Banking its direct negative ruling on the proceedings initiated in April, 2012 concerning the supposedly prohibited BankAdat agreement. The decision obliged the Hungarian Banking Association to pay 4 billion forints in equal installments over the course of 20 months. The decision named banks with access to the database and stated that if an installment was not paid and could not be encashed, it would obligate the banks named in the decision to pay jointly through a separate order.

The Banking Association turned to the Budapest-Capital Administrative and Labour Court to have the decision reviewed and to have the payment obligation suspended. The court overruled the suspension of proceedings at first instance, which we appealed. The Banking Associations and the twenty banks that joined are represented in the proceedings by the Kinstellar and Oppenheim law firms, while the other banks involved chose different representation. An action against the Competition Authority's decision was also submitted by the banks named in the proceedings. The reliefs were put under one docket number by the court, therefore it will hear all cases in one proceeding.

Money Week: a summary of the 2016 programs

Hungary joined the program for the second time this year with outstanding results. The European Money Week program has nearly 30 participating countries. In Hungary, the Banking Association started and coordinated the initiative to join, and the banking sector fully supported it, right from the start: in 2016 it provided 250 volunteer bank experts who actively participated in classes held at schools. In addition, the program was supported by the Ministry of Human Capacities as a professional partner, and the Money Compass Foundation, the emblematic organization of financial education in Hungary. The foundation also took on the role of co-organizer for the programs. "Students and teachers likewise showed immense interest (both last year and this year) in the events of the financial program week" emphasized Mrs. Gáborné Pölöskei, government commissioner of the Ministry of Human Capacities. The Hungarian Money Week reached out to many students even in European comparison: in 2016, 788 elementary and high schools and 1435 teachers joined the program, allowing over 102 thousand students to get acquainted with everyday financial topics, which affect their life. Last year, the core material was the family budget, this year it was the fundamentals of savings and financial planning. Participating elementary and high schools gained access to useful and practical financial knowledge through teaching materials developed separately for 4 different age groups. At the opening ceremony the "Ambassador for Financial Literacy" awards were also given to the two most committed and active contributors to this year's Money Week program: Raiffeisen Bank Zrt. and MKB Bank Zrt.

At their next meeting the Board thanked Ms. Éva Hegedűs, the program's sponsor, Ms. Ágnes Sütő, the chief organizer, as well as the entire staff for their organizational work. A questionnaire was sent to volunteers and teachers to inquire about their opinion of the program. 708 questionnaires were completed with 99.9% of teachers in support of the initiative, considering it either excellent or good. Volunteers responded to most questions positively and also collectively rated the program as either excellent or good.

ITCB compliance course

In March 2013 the ITCB and HBA decided to establish a professional examination for experts of the financial sector, in order to increase efficiency in the battle against money laundering. A preparation course must be completed before the exam can be taken. The ITCB and the HBA set the details of their collaboration in an agreement. In early 2016, the two parties decided (with consideration of market demand) to extend this collaboration to other courses and examinations in the field of compliance as well. They modified their cooperation agreement accordingly in March 2016. The ITCB thus organized the first compliance expert course with the previously determined presenters and theme.

The course took place from April to May, with 15-20 participants for each module. The examination was held in the last week of May, and those who completed it successfully received a course certificate. Feedback from participants was very positive; their comments will be considered in the organization of future courses.

Transferring contact with the Constitution Protection Office to electronic channels

In late December, the Constitution Protection Office (CPO) contacted the Banking Association, asking us to organize a consultation on having inquiries from the CPO to members of the credit institutions sector transferred to an electronic platform. The consultation was held in the middle of January and the CPO explained that in the future, it would send the majority of its qualified inquiries without qualification and in electronic format through the GIROMAIL system. It would thus expect market actors to reply more quickly than before. Bank experts discussed in which cases quicker replies should be expected and the technical limits of the GIROMAIL system. They recommended using NAV's or the Hungarian Chamber of Judicial Officers' systems as an alternative solution, since these systems eliminate most weaknesses and provide better support for the automation of a portion of replies. The CPO insisted on sending electronic letters through GIROMAIL, however it indicated that it will examine the possibility of the introduction of other platforms recommended by the banking sector.

Other working committees, working groups

- *Data protection working committee*

At the meetings of the data protection working committee in Q1 we discussed the data protection aspects of the debt management legislation concept coordinated by MNB and the data protection correlations of debt management activities. We listened to a NAIH's presentation on its examinations in this topic, and on the new electronic ID cards. Other agenda items were: interpretation issues regarding the data protection act; preparing for electronic liaison with courts; the NAIH recommendation on granting preliminary data protection information to clients; and practices in connection with the application of data management based on legitimate interest and the interest

measuring test. The working committee followed the EU's adoption of the new data protection regulation and will discuss preparations for the implementation of the regulation at its next meeting.

○ *The Agricultural working group*

The agricultural working group's meetings in the first quarter can be summarized as follows:

- A representative from the Prime Minister's Office held an informative presentation on the main goals of the Rural Development program for 2014-2020, on the changes to these, on the probable introduction of tenders, on financial allocation, and on changes to the agricultural-environmental management support.

-The Ministry of Rural Development extended its data collection from the *complete credit portfolio of private farms* (valid from 2015) to economic organizations in 2016. The working group commented on the new questionnaire and explanatory note. The collected data can also be found in the Hungarian Central Statistical Office's timeline, broken down in detail according to NACE (TEÁOR), aim of credit, and form of finance management.

- The Ministry of Rural Development's representatives discussed the experience gained from the *going green support*, the actual turnout of the *support tied to production* and the *income stabilizing instruments of Pillar II of the Common Agricultural Policy*.

- The National Land Fund Management Organization's representatives, within the framework of the *"Land to farmers" program*, outlined the *concept for the procedure for purchases affected by lending operations* related to the sale of state owned land to farmers . The working group commented on this. After the consultation the organization compiled the final procedure for lending operations concerning land over 3 hectares.

- The Agriculture and Rural Development Agency's representatives presented the *changes in the electronic submission of the Uniform Application Form for requesting agricultural support*, as well as the *payment procedure for the agricultural-environmental management support*.

Each presentation at the working group's meetings was followed by consultation in detail and the thorough discussion professional suggestions.

○ *SME working group*

The SME working group held three meetings in the first quarter. At the first meeting of the year representatives of the Ministry for National Economy and the Prime Minister's Office shared their evaluation of the *Economic Development and Innovation Operational Programme for micro small and medium enterprises (GINOP 1)*, as well as the application of FAIR, the new database and information system of the 2014-2020 development policy.

At the second meeting issues in connection with the management of EU tenders were discussed with the representatives of the Prime Minister's Office. The Office sent its proposals for amending *Government Decree 272/2014. (XI. 5.) on the procedure of use for certain subsidies from EU funds* with consideration of the working group's comments; the working group commented on this.

At the third meeting European the representatives of the European Investment Bank (EIB) presented the banks 2015 activities and the EIB Group's available products.

○ *Leasing working group*

The leasing working group held three meetings in the first quarter. After determining this year's strategy at its first meeting, the leasing working group invited representatives from BISZ Zrt. who informed us about the summarizing document on the management of HUF converted leasing contracts in the Central Credit Bureau in connection with *Act CXLV of 2015 on resolving issues concerning the HUF conversion of receivables from certain consumer loan agreements*. The working group stated its opinions on the matter.

At its second meeting, with the participation of the Ministry for National Economy's representative, the working group debated comments on the amendment to *Act CCXV of 2015 on modifications targeting the legal harmonization of laws concerning individual actors of the financial intermediary system* and the proposal for the *modification of the financial leasing contract, legislated in the Civil Code*.

At its third meeting, EXIM bank representatives informed us about the *extension regarding the leasing and supplier financing of export aimed investment credit*, which is already available. In addition to this, there was a consultation on the *possibility of extending loan product leasing to improve competition* and EXIM bank's new agricultural strategy was presented.

- *Documentary credits working group*

In Q1 the Documentary credits working group held a multilateral professional consultation on completion, expiry and warranty guarantees, which are most often used in construction. The TSZTSZ ("Professional Organization for the Verification of Completion") and the National Federation of Hungarian Building Contractors were also invited to participate in these. During their meeting, the parties consulted on the issues and proposals in connection with the TSZSZ's proceedings (the organization was established almost three years ago). The result of the consultation was that the TSZSZ compiled a "Guideline", in which it portrays its own role in the fulfillment of architectural, technical planning, construction and contractor contracts in cases of disputes in connection with the drawdown of bank guarantee, on the part of the client, designer, contractor or subcontractor.

Communications

One of the most sought after communications topic of the first quarter was the Hungarian Competition Authority's convicting decision in the BankAdat case. Regarding the fine imposed in connection with the BankAdat service, we issued two press releases, emphasizing that both the banking sector (paying the fine) and the Hungarian Banking Association will satisfy its obligations, however, both deem it to be unacceptable and will therefore seek domestic and international legal remedy.

In Q1 the Family Housing Allowance Scheme (CSOK) also received intense media attention. We published an informational article about CSOK on the Hungarian Banking Association's website. Furthermore, we informed clients about the fact that the banking sector has begun its preparation for the scheme in a statement.

Another important communications topic of the Banking Association was the Money Week program series (started on March 7th) The number of those interested and participants has increased from last year. To promote this event, we held an opening ceremony available to the media, issued two press releases and several other media publications.

Mark Zrt.'s program (to be started on March 21st) also received public attention. Its aim is to cleanse the corporate portfolio of banks. The secretary general, Levente Kovács, welcomed this new opportunity at European level as well.

According to our statistics, in the first 3 months of the year we had approximately 500 online media appearances, followed by around 190 in print media, and roughly 110 appearances in electronic media. Throughout the entire quarter, the Hungarian Banking Association was present or mentioned in Hungarian media over 800 times.

Cooperation agreement with China, preparations to found AFCA

An important step forward in Chinese-Hungarian financial relations was that out of the European Union, only the Hungarian Banking Association was invited to the Boao Forum – a leading Chinese

economic and financial conference, held each year since 2001. Levente Kovács, Secretary General, represented the Hungarian banking sector by contributing verbally at the Roundtable of Financial Leaders and signing a letter of intent about preparations for the founding of AFCA (Asian Financial Cooperation Association). AFCA is planned to be one of the most significant financial associations in Asia. By establishing relations with it right from its start, the Hungarian Banking Association may have been able to create numerous opportunities for useful collaboration for the Hungarian bank system and economy, such as gaining information about the financial sector, strengthening interbank relations or the exchange of research results in finance. One goal is the creation of an international financial cooperation platform, which can be joined by financial leaders and institutions from both Asia and Europe (if invited or recommended).

The cooperation agreement between the Hungarian Banking Association and the China Association of Banks was also signed at this time. The agreement makes it possible for member banks of the two associations to establish relations through which they can efficiently aid investment programs between the two countries. Thus, financial and trade relations between the two countries may be strengthened.

APPENDIX - INTERNATIONAL OUTLOOK: REGULATION AND SUPERVISION

I Global Regulation

I.1 The Financial Stability Board (FSB⁵)

I.1.1 Report on the 2016 objectives of the G20 Finance Ministers and Central Bank Governors

The FSB's priorities for 2016 are the following:

1. Supporting the full and consistent implementation of post crisis reforms, while remaining ready to address any material unintended consequences.
2. Addressing new and emerging vulnerabilities in the financial system, including potential financial stability risks associated with market-based finance, asset management activities, conduct, correspondent banking and climate change.
3. Promoting robust financial infrastructure, working with the CPMI⁶ and IOSCO⁷ to assess policies on central counterparty (CCP) resilience, recovery and resolvability and recommending any necessary improvements.

The FSB will also help the Chinese G20 presidency by:

4. Drawing lessons, working with the IMF and the BIS, from the practical application of macroprudential policy frameworks and tools.
5. Assessing the systemic implications of financial technology innovations, and the systemic risks that may arise from operational disruptions.

I.1.2 Plenary meeting of the FSB in Tokyo at the end of March

At the meeting, the representatives of member countries discussed the following topics:

- Asset management and market liquidity risks;
- Transforming shadow banking into resilient market-based finance;
- Addressing other emerging vulnerabilities;
- Full, timely and consistent implementation of post-crisis reforms;
- Climate-related financial risks;
- Strengthening financial infrastructure;
- Financial system implication of technological innovations;
- Experience with macroprudential policy frameworks and tools.

In addition to the topics listed above, the FSB also discussed steps to improve the effectiveness of OTC derivatives trade reporting; reducing misconduct, following up on the work plan published in November 2015; as well as systemic risks relating to corporate funding structures. The FSB also had a preliminary discussion of ways to promote expanded use of the LEI⁸. Furthermore, the second Emerging Market and Developing Economies (EMDEs) Forum was also held at the meeting, where they reviewed the action plan to address reductions in availability of correspondent banking.

⁵ the highest international body for financial regulation

⁶ Committee on Payments and Market Infrastructures

⁷ International Organization of Securities Commission

⁸ Legal Entity Identifier

I.2 Basel Committee on Banking Supervision (BCBS)

I.2.1 The Basel Committee's 2016 work program

The Group of Central Bank Governors and Heads of Supervision (GHOS) agreed that they will complete their work to address the problem of excessive variability in risk-weighted assets by the end of the year. Thus, – in addition to the review of market risk standards – they will remove the advance measurement approach for operational risk and set additional constraints on the use of the advanced measurement approach for credit risk through the use of floors. They also agreed on the level and calibration of the leverage ratio. The leverage ratio will be based on Tier 1 capital and will comprise a minimum level of 3%. They will discuss additional requirements for global systemically important banks. The leverage ratio requirements will have to be implemented from 2018.

I.2.2 Monitoring the introduction of Basel III standards

The Basel Committee has been publishing the results of Basel III monitoring exercises since 2012. 101 large, Group 1 banks (defined as internationally active, and having Tier 1 capital of more than EUR 3 billion) and 129 other banks (Group 2) participated in the Basel III monitoring exercise, which was based on data from June 30, 2015 and assumes the full implementation of Basel III standards, without a transitional period. Results show that all large internationally active banks meet the Common Equity Tier 1 (CET 1) requirements, as well as the target level of 7.0%, and the surcharges on global systemically important banks (G-SIBs). In the first half of 2015, the additional Tier (AT 1) capital shortfall decreased from EUR 6.5 billion to EUR 3.4 billion for Group 1 banks, while Tier 2 capital short fall dropped from EUR 40.6 billion to EUR 12.8 billion. (As a point of reference, the sum of after-tax profits for Group 1 was EUR 307.2 billion in the period in question.) There was no capital shortfall for Group 2 banks included in the sample for the CET minimum of 4.5%, while for a CET 1 target level of 7.0%, the shortfall has narrowed from EUR 1.5 billion to EUR 0.2 billion.

The weighted average liquidity coverage ratio for Group 1 banks was 123.6%; for Group 2 banks this was 140.1%, thus showing a slight decrease in both groups. All banks reported an LCR at or above the 60% minimum requirement that was in place for 2015, while of the 160 banks in the LCR sample, 84% reported an LCR that met or exceeded 100%. The weighted average Net Stable Funding Ratio (NSFR) for the Group 1 bank sample was 111.9%, while for Group 2 banks the average NSFR was 114.0%. 79% of Group 1 banks and 83% of Group 2 banks reported a ratio that met or exceeded 100%.

I.2.3 The Regulatory Consistency Assessment Programme (RCAP) – Handbook for jurisdictional assessments

The RCAP (established in 2012) consists of two distinct, but complementary work streams to monitor the timely adoption of Basel III standards and to assess the consistency and completeness of the adopted standards, including the significance of any deviations in the regulatory framework. The assessment work is carried out on a jurisdictional as well as on a thematic basis. Currently, the focus of the RCAP is on risk-based capital standards, the LCR, and G-SIBs' framework. However, this will further expand from 2017 to cover standards on NSFR and Leverage ratio.

Based on the experience with the RCAP to date, the Basel Committee has updated the procedures and process for conducting jurisdictional assessments in one document. The Handbook for Jurisdictional Assessments describes the complete assessment program and also introduces questionnaires to be filled out by jurisdictions and to be updated regularly. Both the Handbook and the RCAP questionnaires will help all regulators, supervisors and financial stability authorities to evaluate their own progress with implementation of Basel III framework and identify shortcomings and areas for improvement.

The Committee will regularly update the Handbook and the questionnaire as the scope of the RCAP expands.

1.2.4 Revised capital requirements for market risk

The 2007-08 period of severe market stress exposed weaknesses in the framework for capitalizing risks from trading activities. The set of revisions to the Basel II market risk framework in 2009 aimed to address the most pressing deficiencies. The following fundamental review tackled a number of flawed aspects not addressed by the previous revisions. This has led to the revised market risk framework, which is a key component of the regulatory reforms following the global financial crisis. The purpose of the framework is to ensure that the reviewed approaches (standardized and internal model approaches) deliver credible capital outcomes and promote consistent implementation of the standards across jurisdictions. The final document incorporates the results of the two consultative documents published in October 2013 and December 2014, as well as several quantitative impact studies.

The revised framework includes:

- A revised boundary between the banking and trading books that will reduce scope for arbitrage ;
- A revised internal models approach for market risk with more coherent and comprehensive risk capture;
- An enhanced model approval process and more prudent recognition of hedging and portfolio diversification;
- A revised standardized approach that serves as a credible fallback and floor to the model-based approach, and facilitates more consistent and comparable reporting of market risk across banks and jurisdictions;
- A shift from value-at-risk to an expected shortfall measure of risk under stress;
- Incorporation of the risk of market liquidity.

An explanatory document has been published to provide a non-technical aid for understanding the standards. The revisions to the market risk framework have to be applied from January 2019.

1.2.5 Revisions to the operational risk capital framework

The revisions build on the earlier consultation in October, 2014 and are a part of the Committee's broad objective of balancing simplicity, comparability and risk sensitivity. The Standardized Measurement Approach (SMA) addresses a number of weaknesses in the current framework:

- The SMA will replace the three existing standardized approaches for calculating operational risk capital as well as the Advanced Measurement Approach, thus significantly simplifying the regulatory framework;
- The revised methodology combines a financial statement-based measure of operational risk - the business indicator - with an individual firm's past operational losses. This results in a risk-sensitive framework, while also promoting consistency in the calculation of operational risk capital requirements across banks and jurisdictions; and
- The option to use an internal model-based approach for measuring operational risk- the Advanced Measurement Approaches (AMA) - has been removed from the operational risk framework. The Committee believes that modeling of operational risk for regulatory capital purposes is unduly complex and that the AMA has resulted in excessive variability in risk-weighted assets and insufficient levels of capital for some banks.

The Committee will conduct a quantitative impact study for the final calibration of the SMA. It believes that for most banks these proposals will have a relatively neutral impact on capital requirement. While the objective of these proposals is not to significantly increase overall capital

requirements, it is inevitable that minimum capital requirements will increase for some banks. Comments on the consultative document will be accepted until June 6th.

1.2.6 Consultation on the review of the internal ratings-based approach – reducing model variations

The Committee also initiated consultation on the review of internal qualitative models for determining capital requirements for credit risk (developed and basic). The proposed changes are a key element of the regulatory reform program following the crisis, to be finalized by end-2016. They include a number of measures that aim to reduce the complexity of the regulatory framework and improve comparability and address excessive variability in the capital requirements for credit risk. The Committee proposes to:

- Remove the option to use the IRB approaches for certain exposure categories, such as loans to financial institutions, since – in the Committee’s view – the model inputs required to calculate regulatory capital for such exposures cannot be estimated with sufficient reliability;
- Adopt exposure-level, model-parameter floors to ensure a minimum level of conservatism for portfolios where the IRB approaches remain available;
- Provide greater specification of parameter estimation practices to reduce the variability of risk-weighted assets for portfolios where the IRB approaches remain available.

The final design and calibration of the proposed floors will be informed by a comprehensive quantitative impact study and by ending consultation. The Committee does not aim to significantly increase overall capital requirements.

The consultation period will end on June 24th.

1.2.7 Consultation on the review of Pillar 3 and the disclosure framework

In June, 2014 Committee announced the review of the Pillar 3 disclosure requirements (issued in 2004 and modified in 2009). After the first phase in 2015, the consultative document, which was published in March, means the start of the second phase and includes:

- The addition of a “dashboard” of key metrics,
- A draft disclosure requirement of hypothetical risk-weighted assets calculated based on the Basel framework’s standardized approaches, and
- Enhanced granularity for disclosure of prudent valuation adjustments.

The proposal also incorporates elements, which reflect ongoing reforms to the regulatory framework. These include disclosure requirements for the total loss-absorbing capacity (TLAC) regime for G-SIBs, the proposed operational risk framework, final regulation for market risk, and the interest risk of the banking book. Comments on the consultative document may be made until June 10th.

II European Regulation

II.1 General frameworks

2016 priorities

The following priorities were set in the work program for the Dutch EU presidency in the first half of 2016:

- Strengthening the banking union;

- Creating and developing the capital markets union;
- Strengthening and streamlining the political coordination of the European Semester;
- Supporting the combat against tax fraud and tax evasion.

In addition to the above, the Council will keep working on strengthening the economic and monetary union.

Strengthening the economic and monetary union is also among the Eurogroup's priorities. The financial ministers of the Eurozone set the following additional priorities: structural reforms, promoting employment, a strict budget policy, and reducing debt.

The official launch of the REFIT⁹ Platform

On January 29th as part of the Better Regulation Agenda, the Commission officially launched the REFIT Platform 2015 (announced in Spring 2015). The goal of the platform is to render EU regulation simpler, more expedient and more effective, as well as to reduce costs arising from regulation and therefore to promote the creation of a framework which provides clear, solid and predictable regulation, giving a push to growth and job creation. This goal can be achieved through the joint efforts of the European Parliament, the European Council, The European Commission, member states and the parties concerned. All levels of government must be involved in this work in order that it may cost citizens and businesses as little as possible. The Commission welcomes all comments, suggestions, data and factual information concerning the realization of the regulatory program's goals.

Forty-eight organizations concerned took part, among others representatives from all member state governments took part to ensure better results through better regulation. Input is awaited through the 'Lighten the Load – Have your say' online portal on where and how to decrease unnecessary regulatory burdens. The Commission will process these suggestions. Where suggestions relate to national transposition and implementation of EU law, evaluating these will be the task of the country in question. (Around 250 suggestions were already submitted in 16 topics.)

II.2 The Banking Union

II.2.1 The Single Supervisory Mechanism, The European Central Bank

The ECB's report on supervisory activities in 2015

In her foreword to the report, as well as during her presentation in parliament, Danièle Nouy, Chair of the Supervisory Board, discussed the general developmental tendency of the banking sector, establishing common supervisory methodologies, the harmonization of national options and discretions (NODs), participation in the development of the international regulatory framework of the SSM, and the priorities for 2016. She emphasized that return on equity (ROE) of significant institutions under the ECB's supervision was 4.6% on average in 2015, up from 2.8% the year before, due to lower credit losses. However, the sustainability of these improvements is not guaranteed, since the economic outlook is weak; the low interest rates and flat yield curve environment might stay for longer. The ECB will continually assess the sustainability of banks' business models in the coming quarters.

In 2015, the Supervisory Review and Evaluation Process (SREP) was, for the first time carried out according to a common methodology for the around 120 largest banks/banking groups in the Eurozone. Differences in supervisory practice are mainly caused by regulatory differences, therefore,

⁹ Regulatory Fitness and Performance Programme

within the SSM framework, reducing the number of national options and discretions and their uniform management made possible by the CRR/CRD IV capital requirements received special emphasis.

Banks' business models and increasing their profitability will also remain a priority for 2016 in the SSM. Persistently low interest rates and a heightened level of non-performing assets both pose challenges. Risks that vary from country to country, such as credit risk; reversal of the search for yield; conduct and governance risk; sovereign risk; geopolitical risk and growing vulnerabilities in emerging economies; and IT and cybercrime risk fundamentally determine operating conditions. For 2016, the SSM set the following priorities (which partly agree with the 2015 priorities):

- business model and profitability risk,
- credit risk,
- capital adequacy,
- risk governance and data quality, and
- liquidity.

These priorities apply directly to all significant banks under ECB supervision, to relevant national authorities, and indirectly to less significant credit institutions under ECB supervision.

ECB regulation on the exercise of options and discretions

Following the public consultation announced in November, in March the ECB announced its regulation on the exercise of national options and discretions. The regulation applies to significant banks under the supervision of the ECB. The ECB issued a feedback statement, which in addition to reviewing and analyzing responses, also contains compares it to the draft regulation.

In the second phase of the project they will examine a smaller fraction of the identified NODs provisions (those with lower priority and those which require further work).

Keeping in mind to ensure a level playing field and regulatory consistency, the ECB will also examine if the provisions of the regulations can be extended to credit institutions (indirectly supervised) or if due to differences (e.g. differing business models) it needs to apply distinct rules giving consideration to the principle of proportionality.

The European Commission is examining whether it can unify options and discretions under the jurisdiction of member states.

II.2.2 The Single Resolution Mechanism

Delegated Regulation on the investment strategy and rules for the administration of the SRF¹⁰

The Delegated Regulation lays down general principles and criteria for the investment strategy and rules for the administration of the Single Resolution Fund. The general principles and criteria for the investment strategy are to be adopted by the Single Resolution Board. The investment objectives should constitute one of these elements. In line with the requirement that the Board have a safe and prudent investment strategy, the overarching goal should be to protect the value of the Fund and to satisfy its liquidity requirements. However, due to the intrinsic nature of investments, changing market conditions and interest rate environment, even the safest and most liquid assets may entail negative returns. In this respect, a loss incurred on the portfolio should not imply a violation of the investment objectives.

The Commission's Delegation Regulation on the content of recovery and resolution plans

¹⁰ Single Resolution Fund

The European Commission has published its Delegation Regulation, which supplements the Bank Recovery and Resolution Directive (BRRD) with regard to regulatory technical standards specifying the content of recovery plans, resolution plans and group resolution plans, the minimum criteria that the competent authority is to assess as regards recovery plans and group recovery plans. The regulation also sets conditions for group financial support, the requirements for independent valuers, the contractual recognition of write-down and conversion powers, the procedures and contents of notification requirements and of notice of suspension and the operational functioning of the resolution colleges.

II.2.3 The European Deposit Insurance Scheme (EDIS)

The rapporteur for the proposal on the European Commission's European Deposit Insurance Scheme is Esther de Lange from the European People's Party). In accordance with the public *timetable*, the paperwork for the proposal was completed by early May and the Committee on Economic and Monetary Affairs (ECON) hearing was held on May 23-24. The preliminary rapporteur's report may be published in the summer. ECON may vote on EDIS on November 28-29, with consideration of the modification proposals received. The parliamentary plenary vote may take place in January 2017, depending on the trilateral consultations.

In its *opinion on EDIS*, The European Economic and Social Committee (EESC) stated that its proposal should only be considered in parallel with the Commission's Communication entitled "Towards the completion of the Banking Union", which was published at the same time. It is apparent that the two that the introduction of further risk sharing (see the EDIS proposal) is to be accompanied by further risk reduction in the Banking Union (see the Communication). It therefore appears that the two documents are two sides of the same coin. The EESC welcomes both the legislative proposal for EDIS and the Communication on the completion of the banking union.

The *European Banking Federation (EBF)* supports EDIS as the fundamental principle for the establishment of the third pillar of the completely finished and harmonized banking union. The proposal should be effectuated in a way that it does not jeopardize the level playing field and best practices. The EBF urges a step by step approach allowing more time and consideration for the subsequent steps. Before the common deposit insurance scheme is realized, any remaining significant risks on banks' balance sheets not subjected to the ECB's Asset Quality Review (AQR) should be identified and addressed. There should be no overall increase in individual contributions to deposit insurance due to EDIS.

In its response given during the consultation the EBF laid down several principles and features, which should be adopted for the final design of EDIS.

II.3 Capital Markets Union (CMU)

II.3.1 Public consultation on the regulatory framework of financial services

On September 30, 2015 the Commission launched a public call for evidence on the regulatory framework of financial services with the aim of reviewing hastened legislation in the wake of the financial crisis, filtering out possible mistakes and duplication, and to manage unintended consequences. According to *financial commissioner Jonathan Hill*, nearly 300 responses came in from 20 member states and from outside of the EU in representation of the financial sector and the entire economy. 31 authorities responded to the Commission's propositions, but comments were also received from think tanks, academia, consumer organizations and trade unions. The Commission

will only come up with a proposal after having thoroughly processed and analyzed these responses. The comments received point towards the following three main concerns:

- Legislation is not sufficiently proportionate;
- it could be weighing negatively on the amount of financing available to the wider economy;
- the compliance burden is too high, due to unexpected interactions, duplications and inconsistencies

Respondents call for rules that take greater account of companies' size, business models and risk profiles. A number argue that the capital requirements are too onerous for smaller banks. The EBA¹¹ also recommended that a simpler prudential regime should be developed for smaller investment firms that pose no systemic threat. EMIR's reporting requirements are also too burdensome and costly. Questions were raised about whether the increased costs of hedging coming from prudential requirements are proportionate.

The Commissioner's aim is to ensure that the CRR and CRD IV legislation achieves its prudential objectives but that its requirements for lending to companies are not excessively high. To encourage more investment in infrastructure, they want to look at whether lower capital requirements would be appropriate for lower risk, long-term investments. They will undertake a comprehensive review of liquidity in corporate bond markets. The commissioner will take care to introduce future regulation (NSFR, leverage ratio, TLAC) in way that is beneficial from a European perspective.

Excessive and inconsistent reporting requirements are often not in proportion to actual risk. In order to avoid duplication, the commissioner promised that they will consider very carefully to streamline reporting requirements, to standardize definitions, templates and reporting formats and for common IT tools to be used to lighten the compliance burden.

The European Banking Federation also submitted its response to the Commission's call. It found the date adequate for the review of the regulatory frameworks and explicitly welcomed examining the interaction of the different reforms and their overall effects on banking activity. The EBF raised 55 issues, for which sought to find concrete and proactive that would help to serve the real economy.

II.3.2 Consultation on the efficient regulation of insolvency

In March, the Commission announced a 12-week consultation to establish an efficient framework for insolvency proceedings. The review of insolvency regulation is part of the action plan to create the capital markets union. Two years prior, the Commission had already created the Insolvency Recommendation, which aims for the preventive restructuring of debtors in financial difficulty and discharge periods for honest bankrupt entrepreneurs to provide them with a second chance. Since the recommended reforms were only implemented partially by the deadline set in March 2015, the Commission plans to create legislation in this field. Based on good member state practices, it seeks to establish common principles and standards which could ensure that national insolvency frameworks work well, especially in a cross-border context. The Commission will use the responses received during the consultation to identify which aspects may possibly be dealt with in the legislative initiative and which in other possible complimentary actions in this field. The Commission also published a relevant initial impact assessment report in parallel with the consultation questionnaire.

¹¹ European Banking Authority

II.3.3 Joint note on the European Commission's proposals on simple, transparent and standardized securitization (STS¹²)

This document, has been signed by numerous European banking associations, other financial advocacy groups and big banks. It identifies key elements of the *Commission's proposed regulation on simple, transparent and standardized securitization*, over which the signatories have agreed that changes would be beneficial and necessary to create a safe European securitization market able to support the economy. In order to ensure a safe and sustainable securitization market, several aspects of the Commission's proposal need to be addressed due to the complex and holistic nature of markets. The four basic pillars of the STS European securitization market set that it must be stable, have clear regulation, have a systemic, holistic approach and be executable.

Keeping this in mind, the signatories proposed the following:

- setting clear and usable securitization criteria;
- handling existing securitization (grandfathering);
- the easing of due diligence concerning investors (and harmonization with other regulation on transparent products)
- the proper attestation of originators/sponsors;
- establishing a regulatory framework to oversee independent third party certification mechanism;
- a single point of interpretation for STS criteria (one authority);
- the proper modification of ABCP¹³ regulation;
- the proper calibration of the CRR (which fits other similar risks);
- limiting the risk of STS qualification; and
- aligning the LCR and leverage ratio, as well as completing the STS project as soon as possible.

Early completion is necessitated by the need to remove obstacles to financing the European economy.

II.4 The European Banking Authority (EBA¹⁴)

The 2016 EU-wide stress test

In February the EBA released the methodology and macroeconomic scenarios for the 2016 EU-side stress test. The aim of the stress test (to be run at the highest level of consolidation) is to provide a common analytical framework to consistently compare and assess the resilience of the European banking sector to economic shocks. The EBA did not define any single capital thresholds, as the results will serve as input for the Supervisory Review and Evaluation Processes (SREP) under which relevant authorities will determine appropriate capital resources.

The common methodology of the stress test, which assumes that the balance sheet is static (at the December, 2015 value), assesses solvency and covers all main risk types including credit risk and securitization, market risk, sovereign risk, funding risk, and operational and conduct risks. The adverse scenarios for 2016 to 2018 were designed by the European Systemic Risk Board (ESRB).

The Europe-wide stress test will have 39 participating banks/ banking groups from the Eurozone, and 14 from outside it, each with a balance sheet total of over EUR 30 billion, covering 70% of the banking sector. (National authorities may include others.) The EBA is responsible for coordinating the exercise and will act as a data hub for the final dissemination of the results. National authorities will

¹² Simple, transparent and standardized (Global and European regulatory authorities do not use the exact same terminology, but STC and STS securitizations are the same in content, since standardized products are the ones that can be compared.)

¹³ Asset-backed commercial paper

¹⁴ European Banking Authority

check the quality of the results and decide on any necessary supervisory reaction measure as part of the SREP process. The results of the stress test will be published early in the third quarter of 2016.

Report on SMEs and the SME Supporting Factor

In March, the EBA published a report on small and medium enterprises, which demonstrates and analyzes the evolution of lending trends and conditions, the effective riskiness of the SME sector over a full economic cycle, and the consistency of own funds requirements laid down in the Capital Requirements Regulation (CRR) for credit risk on exposures to SMEs. Overall, the results of the EBA analysis show limited effectiveness of the SME Supporting Factor (SF); they do not prove SF to be an additional incentive for SME lending. Still, the findings of the report rely on empirical evidence for a limited period of time and apply to only a few EU countries. More data is needed before drawing final conclusions, therefore, the EBA recommends continued monitoring of the application of the SF.

EBA's 5th anniversary conference

The conference was held in the prestigious Guildhall and was broadcasted live on the EBA's website. Participants included high level decision makers, industry representatives, academics and other parties of interest from both Europe and beyond. Panelists came from both the state and the private sector and voiced their opinions, priorities regarding regulatory changes and the conformation of business models.

In his opening speech Andrea Enria, Chairperson of the EBA evaluated the results achieved:

- The decisions in connection with the 2011 stress test (the use of a very rigorous definition of capital, asking banks to significantly enhance their capital position in light of the sovereign debt crisis, and the extensive disclosure of banks' data), which showed that despite criticism, the EBA is capable of acting and taking responsibility by shaping coordinated EU-wide policy responses.
- Efforts in connection with the Single Rulebook project (creating over 150 standards and guidelines, initiating uniform standards and guidelines on covered bonds and securitization, creating an integrated system for frequently asked questions and answers). By acting as guardian of the Single Rulebook, the EBA laid down the foundations for a better functioning and truly integrated Single Market.
- The establishment of an open, transparent and accountable organization. The EBA is aiming for an early and open dialogue, to always react to the comments received and to provide a clear timetable for future tasks in order to render its activities predictable. It aims to understand what it is doing and why.

The Chairperson of the EBA mentioned the following challenges among others, for the future:

- monitoring the functioning of the Single Rulebook and enhancing the application of the principle of proportionality;
- completing the adjustment in banks' balance sheets;
- challenges posed by digital banking and consumer protection.

Other EBA and ESA¹⁵ documents published in the first quarter

Guidelines

- EBA publishes revised final draft technical standards and guidelines on methodology and disclosure for global systemically important institutions (EBA/GL/2016/01)
- EBA publishes Guidelines on cooperation agreements between deposit guarantee schemes (EBA/GL/2016/02)

¹⁵ European Supervisory Authorities (EBA, ESMA, EIOPA)

Consultative documents

- EBA consults on draft guidelines on implicit support for securitisation transactions (EBA/CP/2016/01)
- EBA seeks comments on reporting of prudent valuation information (EBA/CP/2016/02)
- EBA consults on draft Guidelines on corrections to modified duration for debt instruments (EBA/CP/2016/03)

Technical standards

- Final draft implementing technical standards amending the Commission Implementing Regulation (EU) No 1030/2014 on the uniform formats and date for the disclosure of the values used to identify global systemically important institutions (EBA/ITS/2016/01)
- EBA publishes final draft ITS on the mapping of ECAs credit assessments for securitisation positions (EBA/ITS/2016/02)
- EBA issues amended standards on supervisory reporting for institutions (EBA/ITS/2016/03)
- ESAs publish final draft technical standards on margin requirements for non-centrally cleared OTC derivatives (ESAs/2016/23)

Opinions

- EBA sets out roadmap for the implementation of the regulatory review of internal models (EBA/OP/2016/01)
- EBA expresses dissent over EU Commission proposed amendments to the MREL technical standards (EBA/OP/2016/02)
- EBA reports on high earners and the effects of the bonus cap (EBA/OP/2016/05)

Reports and other documents

- EBA updates its Risk Dashboard for EU banking sector
 - EBA publishes its annual assessment of EU colleges of supervisors
 - EBA publishes results of the CRDIV-CRR/Basel III monitoring exercise as of 30 June 2015
 - EBA amends DPM and XBRL taxonomy 2.4 for remittance of supervisory reporting
 - EBA publishes new DPM and XBRL taxonomy 2.5 for remittance of supervisory reporting
 - EBA issues revised list of ITS validation rules
 - EBA responds to the European Commission's Green Paper on Retail Financial Services
 - EBA publishes Decision specifying the benchmark rate under the Mortgage Credit Directive (EBA/DC/2016/145)
 - EBA seeks input at national level on FINREP and GAAP
 - EBA launches an impact assessment of IFRS 9 on banks in the EU
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