**Annex 4**

**Information on high-risk portfolios as key priorities in the supervisory review process and on the related additional capital requirement**

Annex 4 forms part of the guidelines entitled “Internal Capital Adequacy Assessment Process (ICAAP), Internal Liquidity Adequacy Assessment Process (ILAAP), and their Supervisory Review Process and Business Model Analysis (BMA) (hereinafter: Guidelines on supervisory review of ICAAP, ILAAP and BMA). It provides an overview of the risk exposures and high-risk portfolios for which the MNB prescribes additional capital requirement upon the calculation of the internal capital requirement of institutions, in respect of which it conducts more stringent inspections. The MNB reviews the high-risk portfolios detailed below on an annual basis.

Pursuant to Article 97*[[1]](#footnote-2)* of CRD V[[2]](#footnote-3), if the MNB identifies risks at institutions with similar risk profile and business model that might pose significant risks to the financial system, it shall be entitled to manage such institutional risks in a similar or identical manner during the supervisory review process pertaining to the ICAAP (hereinafter: supervisory review). The main tool for this exercise is the identification of high-risk portfolios.

The Document covers the portfolios with risk profiles that give rise to supervisory concern in the Hungarian market based on analysis and supervisory information. In order to manage such risks, it is justified and expected that the institutions concerned are required to hold additional capital. As a rule of thumb, the MNB will set additional capital requirement based on the Pillar 1 capital requirement of the existing portfolio with regard to risks and activities specified in the high-risk portfolios, and any divergence from this requirement will be indicated separately for the given portfolio. For each individual portfolio the MNB expects institutions to describe how they handle their high-risk portfolios under Pillar 1 and Pillar 2.

The MNB has imposed this requirement in order to achieve the following main objectives:

* In case of certain risks it should be emphasised that the risk of the given activity is found to be so significant by the supervisory authority that the MNB deems it justified to hold additional capital for coverage.
* As regards certain other risks (products, activities, practices), the MNB's objective is to protect the market from the given risk's uncontrolled spread. In this case, the level of the risk is found to be so significant by the MNB that it poses a severe threat to the institution concerned, to the customers of the institution and, in case of simultaneous risk exposures by several institutions, to the market as a whole.

The level of the additional capital requirement depends on the level of the institution's risk management framework and on the development its applied methodologies.

If the institution under review can duly justify the adequacy of the model or practice applied, the MNB may diverge from these rules in respect of high-risk portfolios.

By applying the principles of competition neutrality and equal treatment, the MNB continues to regard the expectations as part of the general good[[3]](#footnote-4); therefore, it applies the expectations in an identical manner for all market players concerned. This also means that the MNB expects money and capital market players not subject to consolidated supervision in Hungary (including branch offices operating in Hungary) to exhibit a market behaviour that complies with the conditions described below, and the MNB will enforce compliance with such conditions by other supervisory tools and under international cooperation schemes.

Additional capital requirement set for the high-risk portfolios is reviewed by the MNB in the course of the annual ICAAP supervisory review process with the help of the data request template called ‘Data request for reviewing the high-risk portfolios' that can be found on the website. The template must be filled out according to the reference date set by supervisory authority, complying with the level of the supervisory review (individual/consolidated) and the accounting standard applied (i.e. IFRS). In the case of consolidated ICAAP review of portfolios of foreign subsidiaries — if it is justified by local particularities — derogation from the rules of Annex 4 (sic orig.) is allowed. Exposures that are considered risky from several aspects must be included in each portfolio concerned, and according to the applicable regulations for the given portfolio additional capital requirement must be set for each risk separately. Add-ons must be also recognised for the off-balance sheet part of the respective exposures. The terms not defined in this Annex (e.g. non-performing exposures) comply with the definitions of Regulation (EU) No 575/2013/EU (CRR).

***Risks that may arise at institutions subject to the CRD/CRR, treated with high priority by the MNB:***

**1 Coverage of expected losses on non-performing exposures**

The MNB considers it important for the institutions to provide coverage for the losses expected from non-performing exposures by prudently evaluating the coverage and by generating adequate impairment.

In formulating its expectations for high-risk portfolios, the MNB lays emphasis on recognising sufficient impairments in consideration of the following factors:

* the institutions' collateral assessment practices are different;
* the low liquidity of markets impedes the recovery of debt from the collateral applied.

Based on recovery experiences, the MNB determines an average loss rate of 40% for secured retail loan portfolios (i.e. mortgage loans) and for the corporate, project and other non-retail loan portfolios, and requires credit institutions to recognise at least 40% impairment to cover the expected losses on non-performing exposures. Furthermore, based on the impairment coverage data, MNB expects the credit institutions to cover the expected loss on the micro segment’s non-performing exposures by recognising impairment of minimum 50%. Recovery experiences indicate higher loss rate, roughly 80 percent, for unsecured retail (retail loans other than mortgage) loans; therefore, impairment of minimum 80% is expected for unsecured retail loans.

**Level of additional capital requirement**: for non-performing exposures, the difference between the minimum average portfolio-level impairment expected by the MNB and the level of impairment recognised by the institution for the portfolio concerned must be set as additional capital requirement. When calculating the capital add-on, retail exposures shall include the transactions with MNB sector code ’J’ (households), and then the mortgage and other retail exposures (with the exception of the self-employed) must be separated based on their product type in order to verify the impairment level. Based on Article 47c of CRR, the part deducted from the regulatory capital is added to the impairment coverage.

**2** **Balloon/bullet transactions**

Based on past experience, the MNB continues to deem risky the transactions with original maturity of over one year where interests and fees are paid during the term, while the repayment of the total principal or a major part – 60% or higher[[4]](#footnote-5) – thereof becomes due in the last 20% of the tenor. If 20% of the original tenor is shorter than one year, the last one-year phase of the tenor must be taken into consideration. For the purposes of identifying the balloon/bullet transactions the terms defined in Annex 1 to the effective MNB Decree no. 38/2019 (XI. 20.) should be applied.

The MNB does not grant exemption even in the case of balloon/bullet transactions offered in the FGS/MLS[[5]](#footnote-6) scheme from holding a capital add-on, as it believes that this scheme in itself does not ensure the mitigation of the risk arising from the balloon/bullet nature of the transaction.

However, it is not necessary to recognise the add-on capital requirement if each of the conditions listed below is satisfied for the respective exposure:

1. the exposure is to organisations operating or financing physical structures or facilities, systems and networks rendering or supporting basic public services;
2. the low credit risk of the cash flow generated by the obligor is ensured by statutory government scheme;
3. the credit institution applies the recommendations of the Executive Circular on the risk management of balloon/bullet loans and be able to provide supporting documentation.

In respect of subsection b), currently the MNB only takes into consideration the mandatory purchase price prescribed in Act LXXXVI of 2007 on Electricity and the subsidised price of the premium subsidy.

The following are exempted from the obligation regarding to capital add-on:

* corporate bonds, government bonds and institutional bonds with external credit rating,
* the Lombard loans, where the exposures are secured by securities, Hungarian forint (HUF) or foreign currency deposits, and due to their sufficient risk mitigating effect, they are not regarded as high-risk exposures,
* working capital loans with original maturity of maximum 3 years.
* project financing loans for residential property developments for sale[[6]](#footnote-7)

**Level of additional capital requirement**: The capital add-on to be prescribed is 50% of the capital requirement applicable to the respective performing portfolio under Pillar 1, for the credit institutions subject to simplified, comprehensive and focused supervisory review process. The MNB expects institutions to take into consideration the off-balance-sheet exposure in respect of the balloon-bullet portfolios in the case of exposures where after becoming an on-balance sheet item a balloon-bullet exposure is created and the CCF to be applied is not 0. Moreover, the MNB expects institutions to apply, by default, a higher risk weight for balloon/bullet transactions than for non- balloon/bullet transactions in the same portfolio.

**3. Loans denominated in foreign currency**

Due to the higher foreign-exchange risk resulting from the crisis, the retail and SME sector, in particular, faced considerable difficulties in repaying their foreign currency loan portfolio because of the discrepancy between the currencies in which these debtors draw their income and the currency of their loans, which raised the credit risk of institutions with respect to these debtors compared to exposures denominated in the same currency as the incomes or the collateral. With respect to retail segment, the different denomination of the loan currency and the debtors' income has already been addressed by the legislators, however, the risk arising from this may still be present in the non-retail sector.

Foreign currency lending may imply higher residual risk in case the value of the collateral does not rise in line with the increase in the exposure value stemming from the appreciation of the exchange rate; in addition, institutions may also face the concentration of credit risk if the majority of their loan portfolio is denominated in the same foreign currency or in closely correlated foreign currencies.

With due regard to the recommendations of the European Systemic Risk Board[[7]](#footnote-8) on lending in foreign currencies and the Guidelines of the EBA, the MNB continues to consider it crucial that institutions manage the risks related to foreign currency loans appropriately and hold adequate capital to cover risks associated with it if deemed necessary. The detailed requirements of the MNB relating to foreign currency lending are included in the Guidelines on supervisory review of ICAAP, ILAAP and BMA. The level of capital requirement shall be determined based on fulfilling the regulations.

**Level of additional capital requirement**: for all foreign currency-denominated, performing portfolios outstanding to borrowers with no hedge[[8]](#footnote-9), the capital add-on to be recognised is 0-30% of the capital requirement under Pillar 1, uniformly for all institutions subject to simplified, comprehensive and focused ICAAP review. If the credit institution defines 0% capital add-on, it must submit to the MNB the documentation supporting the ratio of 0%.

**4. Repeated loan restructuring**

According to experiences gained in supervisory inspections, it happens increasingly often that certain transactions are repeatedly restructured without adequate provisioning for impairment in consideration of the portfolio's quality.[[9]](#footnote-10) This practice implies substantial risk for individual institutions. Thus the MNB prescribes an additional capital requirement for transactions that have been subject to contract amendment for restructuring purposes according to the regulation in force[[10]](#footnote-11) on at least two occasions since 1 January 2011 (with the exception of participation in the government debt relief programme) where the credit institution granted an additional grace period to the debtor for interest and/or principal repayment.

For further guidance on the treatment of transactions considered restructured due to having spent 9 months in moratorium, see the Frequently Asked Questions on the MNB’s website[[11]](#footnote-12)

**Level of additional capital requirement**: The prescribed capital add-on is 50% of the capital requirement applicable to the respective performing portfolio under Pillar 1, uniformly for the credit institutions subject to simplified, comprehensive and focused supervisory review process.

**5. Retail transactions based on contracts breaching the rules related to PTI, or managed by not sufficiently prudent banking practice**

The aim of the decree on regulating payment-to-income and loan-to-value ratios[[12]](#footnote-13) is to prevent the over-indebtedness of the consumers and to mitigate the systemic credit risks stemming from it. The MNB pays special attention to attaining these objectives; furthermore, it is determined to take strong action against the practices of institutions violating the PTI rules and against their risky practices by taking the necessary measures and applying penalties. An institution is acting unlawfully or in a risky manner, among others, if it violates the PTI limit or it fails to act in a prudent manner (even if it acts in accordance with the provisions of the PTI regulation) when checking the client's monthly net income and determining the total debt service. Those cases are deemed to breach the PTI rules, when during its lending process the Bank fails to comply – or does not comply in full – with the rules related tothe manner of calculating the PTI, to the application the payment-to-income ratio (PTI), or to the applicable exceptions or any other PTI-related provisions.

The MNB considers it justified to prescribe additional capital requirement when it identifies infringement and the respective transactions are not treated sufficiently prudently.

The MNB also prescribes additional capital requirement when the institutions do not violate the PTI rules, but fail to act prudently, meaning that the Bank fails to assess the client’s income position and total monthly debt service sufficiently thorough. The MNB is of the opinion that in order to investigate the clients’ income position thoroughly and assess their other loan debts, institutions are expected to make full enquiry in the Central Credit Information System (CCIS) of the information available on the client (negative events and positive credit history).

**Level of additional capital requirement**: Retail transactions, falling under the PTI regulation, but contracted by the institutions contrary to the rules applicable to the prescribed PTI, (irrespective of the type of the supervisory review) the total gross exposure must be covered by capital. If due to the absence of the consumer’s consent, the Bank is not able to enquire on the positive credit history in CCIS and in its internal regulation it did not prescribe the negative assessment (rejection) of such loan application, but the verification of the credit worthiness may be performed based on data originating from other sources, the Bank is obliged to keep records of such transactions – after the application deadline (1 October 2019) – in a clear manner (flag them in its systems/subledger) and cover the total gross exposure by capital. If the Bank fails to flag the transactions where the positive credit history data were not enquired on CCIS prior to the loan assessment, it must recognise capital requirement for the entire relevant portfolio falling under the PTI regulation and disbursed after the application deadline in such a way that the total gross exposure is fully covered by capital. That is, the sum of the Pillar 2 capital requirement and the impairment should reach the amount of the total gross exposure. If this criterion is not satisfied, the institution shall recognise the difference between the gross exposure and Pillar 2 capital requirement + impairment for the portfolios of particularly high risk.

It shall be avoided that financial institutions indirectly finance (from funds provided by banks) clients without consent to the positive CCIS enquiry; accordingly, prior to lending to or refinancing financial institutions pursuing retail lending, the Bank must ascertain that the financial institution stipulated in its internal regulations and/or in the general terms and conditions of the products that loan assessment is conditional upon the consent to enquiries on positive credit information data. Failing this, the Bank shall recognise capital requirement for its total outstanding new exposure to the financial enterprise in such a way that the total gross exposure is covered by capital (in accordance with the details described above), irrespective of the loan purpose.

The modified requirements of thishigh-risk portfolio (5) must be applied after 1 October 2019 to a) loans granted by banks to clients, and b) refinancing, regularly prolonged revolving or other loans granted by banks to financial institutions. If the financial enterprise provides the bank with the information, in the form of data supply, on the proportion of its transactions disbursed after the aforementioned deadline that were assessed without positive CCIS approval, the rule that the total gross exposure must be covered by capital applies only to the part of the portfolio that was assessed without positive CCIS approval.

**6. Repossessed assets**

According to the MNB's experiences gained in supervisory inspections thus far, the value of the repossessed assets has deteriorated significantly as a result of the real estate market developments observed in the years of the crisis. The real estate taken over often performs poorly in the first place, and the receiving institution also faces significant challenges in attempting to operate such real estate efficiently. The operating and maintenance costs of real estate may consume substantial resources, which is reflected as a significant expense in profit and loss accounts, while uncertainties hidden in the estate's appraisal (e.g. changes in the owner occupancy rate) give rise to severe volatility in respect of the real estate's book value.

The MNB's reviews conducted thus far revealed that the calculation of the capital requirement for repossessed real estate varies significantly among individual institutions. In the MNB's opinion, the 100% risk weight (i.e. the 8% capital requirement) for credit institutions applying the standardised approach would not cover the risks associated with the repossessed real properties upon a potential crisis, and thus the MNB prescribes a uniform additional capital requirement for these credit institutions and for credit institutions that apply a model where the MNB – in its Pillar 2 review – did not accept the capital requirements based on the internal models.

Furthermore, if the institution provides loan for a company outside of the prudential consolidation (third party) for financing repossessed real estates, with the aim to directly support the purchasing of real estates that served as collateral of certain problematic exposures in a way that it would not be included in the consolidated balance sheet, then it has to hold additional capital.

**Level of additional capital requirement**:100% of the Pillar 1 capital requirement of the repossessed real estate portfolio.

In the case of loan provided for a company outside of the prudential consolidation (third party) for financing repossessed real estates, the level of the additional capital requirement is also the 100% of the Pillar 1 capital requirement.

When there is a high level of concentration (e.g. compared to own funds) in the real estates acquired in lieu of receivables, the MNB may deem it necessary to prescribe additional capital requirement.

1. Directive (EU) 2019/878 of the European Parliament and of the Council amending Directive 2013/36/EU as regards exempted entities, financial holding companies, mixed financial holding companies, remuneration, supervisory measures and powers and capital conservation measures [↑](#footnote-ref-2)
2. Article 97: Supervisory review process and evaluation

   (4a) Competent authorities may tailor the methodologies for the application of the review and evaluation referred to in paragraph (1) of this Article to take into account institutions with a similar risk profile, such as similar business models or geographical location of exposures. Such tailored methodologies may include risk-oriented benchmarks and quantitative indicators, shall allow for due consideration of the specific risks that each institution may be exposed to, and shall not affect the institution-specific nature of measures imposed in accordance with Article 104. [↑](#footnote-ref-3)
3. According to the EU Commission's explanation No. 97/209/6, the following constitutes protection of the general good: “protection of the recipient of services, protection of workers, including social protection, consumer protection, preservation of the good reputation of the national financial sector, prevention of fraud, social order, protection of intellectual property, cultural policy, preservation of the national historical and artistic heritage, cohesion of the tax system, road safety, protection of creditors and protection of the proper administration of justice.” [↑](#footnote-ref-4)
4. the ratio shall be examined upon disbursement or contract amendment; normal amortisation should not be taken into consideration [↑](#footnote-ref-5)
5. FGS: Funding for Growth Scheme (in Hungarian: Növekedési Hitelprogram (NHP)  
    MLS: Market-based Lending Scheme (in Hungarian: Piaci Hitelprogram) [↑](#footnote-ref-6)
6. in accordance with the provisions of MNB Recommendation 1/2021 (I.27.), residential property development project financing loans are those project financing loans where the repayment is expected to be made in whole or in part from the sale of properties designated in the Land Register as apartments. [↑](#footnote-ref-7)
7. Recommendation of the European Systemic Risk Board (21 September 2011) on foreign currency lending (ESRB/2011/1), and <http://www.eba.europa.eu/documents/10180/655339/EBA_2014_00040000_HU.pdf/16205104-550a-4183-9155-c803a86bbce9>. [↑](#footnote-ref-8)
8. “Unhedged borrower”: retail and SME borrowers without a natural or financial hedge that are exposed to a currency mismatch between the loan currency and the hedge currency; natural hedges include in particular cases where borrowers receive income in a foreign currency (e.g. remittances/export receipts), while financial hedges normally presume that there is a contract with a financial institution. [↑](#footnote-ref-9)
9. The MNB interprets restructuring as set out in Government Decree No. 250/2000 (XII. 24.) on the special provisions regarding the annual reporting and bookkeeping obligations of credit institutions and financial enterprises until 31.12.2016, and from 01.01.2017 it interprets restructuring as set out in MNB Decree No 39/2016 (X.11.) on prudent requirements relating to non-performing exposures and restructured claims. [↑](#footnote-ref-10)
10. Until 31.12.2016: Government Decree No. 250/2000 (XII. 24.) on the special provisions regarding the annual reporting and bookkeeping obligations of credit institutions and financial enterprises. As of 01.01.2017: MNB Decree No 39/2016 (X.11.) on prudent requirements relating to non-performing exposures and restructured claim. [↑](#footnote-ref-11)
11. https://www.mnb.hu/letoltes/moratorium2-gyik-0423-final.pdf [↑](#footnote-ref-12)
12. MNB Decree No 32/2014 (IX/.10.) on regulation of the Payment-to-Income Ratio and the Loan-to-Value Ratio [↑](#footnote-ref-13)