Executive circular

Please note this is an unofficial translation, thus in case of divergence of interpretation the Hungarian text shall prevail.

DEPUTY GOVERNOR FINANCIAL INSTITUTIONS SUPERVISION AND CONSUMER PROTECTION

Executive Circular on using macroeconomic information and the factors indicating a significant increase in credit risk under the IFRS 9 standard

This circular is addressed to the financial institutions that prepare their financial statements based on the International Financial Reporting Standards (IFRS) in accordance with Act C of 2000 on Accounting, have their seat in Hungary and are subject to the laws specified in Article 39(1) of Act CXXXIX of 2013 on the Magyar Nemzeti Bank (hereinafter: MNB Act), and the Hungarian branches of third country financial institutions (hereinafter: financial institutions).

The Magyar Nemzeti Bank (hereinafter: MNB) pays special attention to the prudential issues related to the financial institutions' transition to the application of the International Financial Reporting Standards (IFRS), especially the procedural and methodological developments linked to the IFRS 9 standard, with a special focus on the classification and assessment of financial instruments. In this context, the MNB:

- conducted two surveys among financial institutions with respect to the application of the IFRS 9 standard[1] in 2017, in order to identify the most important elements of the IFRS 9 transition, specifically the changes in impairment accounting practices, and

[1] http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv%3AOJ.L_.2016.323.01.0001.01.ENG

- published a recommendation on the issues related to the application of the impairment requirements of IFRS 9 in 2017.[2]

Based on the aforementioned surveys, the MNB has found that there are major methodological differences in the IFRS 9 impairment accounting practices developed by supervised institutions in three areas:

- first, the method of taking into account macroeconomic information, both during the identification of a significant increase in credit risk and the estimation of the probability of default (hereinafter: PD),
- second, the choice and examination of the other factors indicating a significant increase in credit risk (hereinafter: Stage 2 indicators),
- finally, the establishment of the criteria for classification into the Stage 3 category. The overwhelming majority of institutions (determined on the basis of market share or numbers), has equated the concept of Stage 3 under IFRS 9 with the concept of default as specified in MNB Decree No. 39/2016 (X. 11.) on the Prudential Requirements Related to Non-performing Exposures and Restructured Receivables (hereinafter: MNB Decree No. 39/2016 [X. 11.]), while a smaller group applies additional features during classification.

These differences entail divergent bookkeeping, accounting and assessment practices among the credit institutions applying the IFRS, which makes it difficult to compare the risks inherent in the financial instruments with the same characteristics, and the portfolios of the institutions with very similar operating activities and working characteristics. The MNB believes that it should communicate to the institutions not only the obligation of taking into account the core principles determined in international accounting standards, but also the necessity of introducing the best practice expected by it in the above-mentioned three areas and recommend the uniform application of these requirements to ensure that prudential risks are interpreted uniformly and recognised in accounting records along the same principles across the sector.

With respect to the factors indicating a significant increase in credit risk, the macroeconomic scenarios used in the impairment calculations and the correlation between the NPL and Stage 3 categories, the MNB formulates its recommendations, developed after prior arbitrations with the Hungarian Banking Association, as follows.

Identified best practice for taking into account macroeconomic information

In the MNB's experience, the overwhelming majority of financial institutions take into account the results of macroeconomic scenarios during PD estimates in order to comply with Section B5.5.4 of the IFRS 9 standard. Although in and of itself this practice is not objectionable from a methodological perspective, there are large differences in the macroeconomic scenarios used by financial institutions. Accordingly, the MNB considers it good practice to use the macroeconomic projections published in the MNB's Inflation Report[3] during the forward-

---

[2] Recommendation No. 12/2017 (XI.6.) of the Magyar Nemzeti Bank on the issues related to the application of the impairment requirements of IFRS 9 (hereinafter: MNB Recommendation No. 12/2017 [XI. 6.]) https://www.mnb.hu/letoltes/12-2017-ifrs-9.pdf

[3] http://www.mnb.hu/en/publications/reports/inflation-report

looking PD estimates for resident retail customers and companies registered in Hungary, in line with Section B5.5.14(b) of the IFRS 9 standard. When using macroeconomic data and scenarios employed for forecasting Hungarian economic developments and derived from other sources, the MNB expects financial institutions to justify the reasons for deviating from the projections in the MNB's Inflation Report.

In the case of any deviation from the good practice described in the present circular, the MNB deems it necessary to prepare the following documentation and revise it annually, if necessary:

- description of and brief economic justification for the underlying assumptions of the macroeconomic projection prepared or used by the institution,
- comparison of the institution's projection and the projections in the MNB's Inflation Report by macroeconomic time series,
- comparison of the favourable and adverse scenarios of the institution and in the MNB's Inflation Report as well as the projections' "fan charts", and a brief economic justification for any difference.

The MNB considers it good practice if the institution also provides brief justification for the deviation from the MNB's Inflation Report in the Notes section of the annual financial statements for the given reporting period.

Identified best practices in measuring significant increases in credit risk

In order to ensure that the individual institutions converge, in terms of the substance, in measuring the significant increase in credit risk, the MNB recommends that in addition to the compliance with the general requirements laid down in MNB Recommendation No. 12/2017 (XI. 6.), with respect to managing the significant increase in credit risk in the retail and corporate portfolio segments, the expectations on the Stage 2 indicators in Section 5.5.9 of the IFRS 9 standard identified in the surveys and detailed below be implemented in the manner identified as best practice. The MNB considers it good practice to use the Stage 2 indicators presented in this circular, therefore, based on an appropriate cost–benefit analysis (taking into account Section 5.5.11 of the IFRS 9 standard), if the implementation does not impose undue burden on financial institutions, it recommends that the indicators be incorporated into institutions' impairment accounting processes under the IFRS 9 by 1 January 2019.

- With respect to the retail portfolio segment, the Stage 2 indicators identified as best practice are as follows:
    - payments 30+ days past due (except when this is not warranted by the assessments carried out with due consideration in line with Section 35 of MNB Recommendation No. 12/2017 [XI. 6.]);
    - status matching the definition of restructuring, pursuant to MNB Recommendation No. 12/2017 (XI. 6.);
    - at least in the case of the transactions disbursed after 1 January 2015, but when warranted by the institution's own backtesting, in the case of the whole retail mortgage portfolio, and pursuant to Section 3(1) of MNB Decree 32/2014 (IX. 10.) on Regulating the Payment-to-Income and the Loan-to-Value Ratios, with respect to the retail products and LTV specified in the Decree, a significant increase in and/or a measurement of over 95% for the loan-to-value ratio (hereinafter: LTV) while

monitoring the LTV after disbursement. During the monitoring of the LTV after disbursement, the practice considered appropriate is to determine the ratio by dividing the last market value as specified in the relevant law and MNB Recommendation No. 11/2018 (II.27.) by the current principal;

    - transaction or behavioural variables enabling the early identification of a significant increase in the credit risk of the transaction as compared to the time of disbursement within the classification system or as monitoring signals, primarily for the early identification of the potential adverse changes in the income position or solvency of the borrower. In the case of the customers with both savings and investment products at the financial institution, complete risk indicators should be derived from the transaction behaviour based on the account movement information for the savings, investment and credit products, while in the case of the customers with only credit transactions, repayment behaviour indicators should be derived with any kind of measurement or analysis complementing this information.

- With respect to the corporate segment,[4] the Stage 2 indicators identified as best practice are as follows:
    - payments 30+ days past due (except when this is not warranted by the assessments carried out with due consideration in line with Section 35 of MNB Recommendation No. 12/2017 [XI. 6.]);
    - status matching the definition of restructuring,[5] pursuant to MNB Recommendation No. 12/2017 (XI. 6.);
    - other monitoring indicators detailed in the Annex and entailing a justified Stage 2 classification based on the assessments carried out with due consideration.

Incorporating the Stage 2 indicators in the present circular into the impairment accounting process of financial institutions is not always relevant—that is, the signal from a given indicator may not mean a significant increase in credit risk at the institution as compared to the time of disbursement due to internal processes or other reasons—or it may entail disproportionately high costs in accordance with Section 5.5.11 of the IFRS 9 standard. In view of this, the MNB deems it acceptable to disregard one or more Stage 2 indicators presented in this circular if the financial institution demonstrates in the relevant documentation[6] that:

- it uses an indicator or indicators for the significant increase in credit risk that, from the perspective of the measurement, are almost the same in terms of substance as the Stage 2 indicators presented in this executive circular, i.e. the credit risk measurement processes cover the cases of the significant increase in credit risk that are measured by the Stage 2 indicators in this circular, or the given indicator's signal does not mean a significant increase in credit risk at the financial institution as compared to the time of disbursement due to internal processes or other reasons, and

[4] For a detailed breakdown of the microenterprise, the small and medium-sized enterprise and the large enterprise segments, see Annex 1. The corporate segment is without corporate projects. The MNB's recommendations on the latter are included in Section 6 of MNB Recommendation No. 12/2018 (II.27.).

[5] In accordance with MNB Decree No. 39/2016 (X.11.)

[6] the Notes section of the annual financial statements for the given reporting period

- it proves through a cost–benefit analysis that using the Stage 2 indicators in this executive circular entails undue costs for the financial institution due to the above or for other reasons.

With respect to the previous two points, both the qualitative and the quantitative factors have to be appropriately documented and presented to the MNB, i.e. a comprehensive justification and analysis with respect to both the process and the measurement has to be provided so that the MNB obtains an accurate picture about the financial institution's Stage 2 classification process as well as the group of risks sought to be monitored by the financial institution during risk measurement. The MNB considers it good practice in the case of Stage 2 indicators as well if financial institutions point out in the Notes section of the annual financial statements for the reporting period when one or more Stage 2 indicators specified in the present executive circular are disregarded.

The relationship between the Stage 3 exposures under IFRS 9 and the non-performing exposures under MNB Decree No. 39/2016 (X. 11.)

The MNB notes that although in the majority of the cases the Stage 3 exposures under IFRS 9 and the non-performing exposures under MNB Decree No. 39/2016 (X. 11.) overlap, there may be differences that financial institutions need to take into account. In addition to the "20% rule" in Section 6(2) of MNB Decree No. 39/2016 (X. 11.), the client level focus of prudential classifications and the temporal difference between the reclassifications in the two systems (exposures are placed into the non-performing category at a different time than into Stage 3) may also cause a difference.

The MNB believes that it is warranted that financial institutions appropriately present and document the exposures that are identified as non-performing exposures during receivables classification but are recorded as Stage 2 or Stage 1 under IFRS 9, providing the justification for the divergence from the Stage 3 classification.

The MNB will pay special attention to the implementation of the executive circular during continuous supervision and on-site inspections to prevent undue differences at financial institutions with respect to impairment accounting due to methodological differences.

Budapest, 25th June 2018

Dr László Windisch,
Deputy Governor of the Magyar
Nemzeti Bank

Annex to Executive Circular No. …/2018

Stage 2 indicators identified as best practice during monitoring

No.	Monitoring signal	Micro-enterprises	Small and medium-sized enterprises	Large enterprises
Payment difficulties, collection of payments				
1	**The reason behind the payment difficulties and whether the collection is a one-off event or regular needs to be evaluated in all cases.** Late payment of the principal, interest and other fees related to outstanding own-bank risk-taking	X	X	X
2	Receipt of collection on the bank account at the financing bank	X	X	X
Signals obtained during corporate audit				
3	**It has to be evaluated in all cases whether a new commitment threatens the viability of the company and what causes the default.** CCIS audit Established in the case of loans with other banks based on the CCIS status report: - new borrowing	X	X	X

	- default status of existing loans (date, amount, settlement status) - debt servicing data for existing loans			
4	**All changes to data need to be checked, and customers are expected to fulfil their notification obligation and present the related documents.** Changes to debtor data: - new owner **(the new owner has to be examined and met)** - new registered office, - company registration number, **(the audit also has to include whether the change is merely technical or, for example, it signals an impending liquidation)** - tax number	X	X	X
5	Adverse changes to the borrower’s life or activities: **The monitoring has to include the reason behind the change and its impact on debt servicing.** - lower account turnover - main activity changes and/or the cash flow derived from that is insufficient for debt servicing - customer base diminishes	X	X	X
6	The debtor company’s equity dramatically declines		X	X

No.	Monitoring signal	Micro-enterprises	Small and medium-sized enterprises	Large enterprises
7	Drastic change/decline in headcount at debtor company **(the reason behind this process needs to be analysed, whether it is a change in the economic environment or, for example, a “transfer” to another firm)**		X	X
Coercive measures initiated				
8	Enforcement proceedings launched against the company (e.g. by the National Tax and Customs Administration)	X	X	X
Changes to collateral				
9	In the case of non-property project financing, the project is not or not fully realised and/or it cannot generate the debt service. In the case of property project financing, the application of the Stage 2 identifiers as specified in the MNB’s property project financing recommendation.		X	X

10	Failure to pay the insurance premium (e.g. 30-day default or inactive status of contract)	X	X	X
11	Negative change in collateral coverage, which suggest a significant adverse change in the entity's solvency (large depreciation in the value of means of production) or willingness to pay (collateral enforcement)	X	X	X
Other information verifiable during monitoring				
12	**Unique assessment of all circumstances that would threaten the returns of the financial institution from the given transaction.** Other covenants Change in other covenants determined in the Contracts.	X	X	X
13	Deterioration of reporting discipline Late provision of customer-, transaction- and collateral-level data by the customer	X	X	X
14	Legislative change adversely affecting the financial management of the customer Assessment of the customer, the customer's financial management and the legislative changes closely linked to the customer's financial management.	X	X	X
15	Emergence of negative information News report on the customer, customer group, its partners or the industry.	X	X	X

16	Deterioration of financial indicators - Negative change in the indicators calculated during the quarterly classification.	X	X	X
17	Significant adverse change in the sectoral outlook	X	X	