

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 Assessment (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 an 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 103¹ of CRD IV², 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 (hereinafter: supervisory review) pertaining to the internal capital adequacy assessment process (ICAAP). The main tool for this exercise is the identification of risky portfolios.

The Guidelines cover 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. The MNB will set, as a rule of thumb, additional capital requirement for 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.

¹ Article 103: Application of supervisory measures to institutions with similar risk profiles

(1) Where the competent authorities determine under Article 97 that institutions with similar risk profiles such as similar business models or geographical location of exposures, are or might be exposed to similar risks or pose similar risks to the financial system, they may apply the supervisory review and evaluation process referred to in Article 97 to those institutions in a similar or identical manner.

² Directive 2013/36/EU of the European Parliament and of the Council on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC

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 standards of the institution's risk management framework and on the quality and reliability of ICAAP calculations. Accordingly, in some cases the MNB requires the application of different capital calculation methods for institutions subject to complex supervisory review and/or applying internal ratings based approaches and for those subject to standard and simplified supervisory review and applying standardised approach.

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 good³; 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.

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."

Additional capital requirement set for the risky 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 risky portfolios' that can be found on the website. The template has to be filled in according to the reference date set by supervisory review process, complying with the level of the supervisory review (individual/consolidated) and the accounting standard applied (HAS/IFRS). In the case of consolidated ICAAP supervisory review of portfolios of foreign subsidiaries — if it is justified by local particularities — derogation from the rules of Annex 4 is allowed. Exposures that are considered risky from several aspects have to be included in each portfolio concerned, and according to the regulations applying to the given portfolio, additional capital requirement has to be set for each risk separately. Terms used in this Annex (e.g. non-performing exposures, retail 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 loan portfolios, and requires credit institutions to recognise at least a 40% impairment to cover the losses expected from non-performing portfolios. Recovery experience indicates a higher loss rate — approximately 80% — for

unsecured loans; therefore, a minimum 80% impairment is expected for unsecured loans on average.

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.

2. Balloon/bullet transactions

Based on experiences of recent period, the MNB continues to regard risky those transactions with a maturity of over 1 year where interests and fees are repaid during the term, while principal repayment (either the entire amount or a dominant, at least 60% portion of it) falls due upon the expiry of the loan.

The MNB does not grant exemption even in the case of balloon/bullet transactions offered in the FGS/MLS 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.

Level of additional capital requirement: in the case of the institutions subject to complex supervisory review and/or applying internal ratings based approaches, 50% of the concerned performing portfolio's capital requirement under Pillar 1 is the additional capital requirement, which shall be imposed. Divergence from the 50% general rule is possible in the case of the transactions where the Pillar 2 risk weight is in excess of 250%. Over a risk weight of 250%, holding additional capital add-on is not necessary. In the case of credit institutions subject to standard and simplified supervisory review and applying standardised approach, the additional capital requirement may be imposed in the range of 50–100% of the Pillar 1 capital requirement of the portfolio concerned. 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.

If the institution can demonstrate that it appropriately manages the risk from the balloon/bullet transactions in its models, and conducts separate analyses for this (e.g. based on the default rate, the institution has back-tested that the clients defaulted due to the balloon/bullet scheme, therefore the extra risk arising from

the balloon/bullet transaction has been taken into account in the PD indirectly), the required 50% add-on may be reduced.

3. Loans denominated in foreign currency

Owing to the higher foreign exchange risk resulting from the crisis, households and SMEs, in particular, face considerable difficulties in repaying their foreign currency loans 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 households, 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 Board⁴ 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: in the case of the institutions subject to complex supervisory review and/or applying internal ratings based approaches, 0-100% of the capital requirement of the portfolios denominated in foreign currency

⁴ 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.

under Pillar 1 towards all unhedged borrowers⁵ (for example company customers satisfying the criteria stemming from the definition), while in the case of credit institutions subject to standard and simplified supervisory review and applying standardised approach for calculating capital requirement of the credit risk, 10–100% of the Pillar 1 capital requirement of the portfolio concerned.

4. Repeated 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.⁶ 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 force⁷ 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; however, the increased risk this entailed was not accompanied by an increase in impairment.

Level of additional capital requirement: in the case of the institutions subject to complex supervisory review and/or applying internal ratings based approaches, 50% of the concerned performing portfolio's capital requirement under Pillar 1 is the additional capital, which shall be imposed. In the case of credit institutions subject to standard and simplified supervisory review and applying standardised approach, the additional capital requirement may be imposed in the range of 50–100% of the Pillar 1 capital requirement of the portfolio concerned.

⁵ "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.

⁶ 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, 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 claim.

⁷ See footnote 6.

5. Retail transactions based on contracts violating the MNB Decree (No 32/2014 (IX.10.)) on regulating payment-to-income and loan-to-value ratios

The aim of the above-named decree is to prevent the over-indebtedness of the consumers and to mitigate the systemic credit risks stemming from it. The MNB pays particular attention to reach these aims; furthermore, it is determined to take strong action against the practices violating the regulations of the Decree on regulating payment-to-income and loan-to-value ratios and against the risky institutional 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 credit limit or it does not act in a prudent manner (although in accordance with the Decree on regulating payment-to-income and loan-to-value ratios) when checking the client's monthly net income and determining the complete debt service.

The MNB considers it justified to determine additional capital — depending on the level of infringement — in the case of infringement and not appropriate management of transactions affected.

The MNB may determine additional capital requirement in the case of institutions not violating the above-mentioned decree but acting in a non-conservative manner, if the institution does not examine the client's income position and complete monthly debt service adequately (for example it relies on the client's declaration).

Level of additional capital requirement: both in the case of the institutions subject to complex supervisory review and/or applying internal ratings based and institutions subject to standard and simplified supervisory review, retail transactions subject to the Decree on regulating payment-to-income and loan-to-value ratios but contracted different from the regulations, additional capital requirement may be imposed to reach the level of capital requirement determined by 1250% risk weight. In the case of the institutions acting in accordance with the credit limit, but violating the above-mentioned decree in other aspects or not acting in a sufficiently conservative manner, the MNB determines the amount of additional capital in proportion with the capital requirement of the portfolio concerned under Pillar 1 (depending on the level of infringement and risky practice).

6. Real estate portfolio received to offset outstanding claims

According to the MNB's experiences gained in supervisory inspections thus far, the value of the real estate portfolios received to offset outstanding claims has deteriorated significantly as a result of the real estate market developments observed in recent years. The real estate taken over often performs poorly in the first place, and the receiving institution faces significant challenges in attempting to operate such 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 estate's book value.

The MNB's reviews conducted thus far revealed that the calculation of the capital requirement for real estate received to offset outstanding claims varies significantly among individual institutions. In the MNB's opinion, the 100% risk weight (i.e. the 8% capital requirement) for credit institutions applying standardised approach does not cover, in the current real estate market situation, the risks associated with the real estate taken over; therefore, the MNB prescribes a uniform additional capital requirement for these credit institutions and for credit institutions that apply models in the case of which the MNB – in its Pillar 2 review – did not accept the capital requirements as calculated by the internal models.

Furthermore, if the institution provides loan for a company outside of the prudential consolidation (third party) for financing real estates received to offset outstanding claims, which aims to support directly purchasing real estates associated with problem 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 real estate portfolio received to offset outstanding claims.

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