Methodological note:

Identification of other systemically important institutions and the determination of their capital buffers

Financial institutions qualifying as systemically important are the subjects of special regulatory requirements and supervisory monitoring due to their role played in the financial intermediary system and to their weight in the financing of the real economy. The financial regulation harmonised at EU level (Capital Requirements Directive IV – CRD IV) distinguishes global and other systemically important institutions (G-SIIs / O-SIIs).[1] The other systemically important institutions are identified by Member States' competent or designated authorities. These authorities had to determine the list of other systemically important institutions – credit institutions and investment firms – by 1 January 2016 the latest.

The maintenance of institution-specific O-SII capital buffer may be required from other systemically important institutions in order to strengthen the institutions' shock absorbing capacity. The MNB is entitled to classify the institutions domiciled in Hungary as global or other systemically important institutions as well as to set an O-SII capital buffer.

The MNB publishes the list of other systemically important institutions, the score quantifying their systemic importance and the size of the required O-SII capital buffer every year.

1. Legislative background

Pursuant to Article 35(1)b) of Act CXXXIX of 2013 on the Magyar Nemzeti Bank, Article 89(3) of Act CCXXXVII of 2013 on Credit Institutions and Financial Enterprises (Credit Institutions Act) and Article 110/D(3) of Act CXXXVIII of 2007 on Investment Firms and Commodity Dealers, and on the Regulations Governing their Activities, the MNB, acting within its macroprudential mandate, identifies and annually reviews the set of global and other systemically important credit institutions and investment firms authorised in Hungary, and continuously monitors their operations. The identification of systemically important credit institutions in the European Union takes place on the basis of uniform principles, in accordance with the Guidelines of the European Banking Authority (EBA) (EBA/GL/2014/10).

Pursuant to Article 35(2) of Act CXXXIX of 2013, the MNB is entitled to set additional capital buffer requirement to strengthen the shock absorbing capacity of other systemically important institutions. Pursuant to Article 90 of the Credit Institutions Act, the capital buffer determined by the MNB shall consist of Common Equity Tier 1 capital, and shall be supplementary to the minimum capital requirement defined in Article 92 of Regulation (EU) No 575/2013 (CRR), the capital conservation buffer, the countercyclical capital buffer and the additional capital requirement prescribed within the framework of the supervisory review. The capital buffer for the other systemically important institutions shall not be higher than 2 per cent of the total risk exposure amount defined in Article 92 of Regulation (EU) No 575/2013.

[1] At present, there is no institution domiciled in Hungary that would qualify as global systemically important institution according to the evaluation methodology determined by the Basel Committee.

2. Identification methodology

The MNB identifies other systemically important credit institutions in compliance with the EBA Guidelines.[2] During the two-step identification process, the scoring of institutions is first carried out on the basis of the so-called Standard methodology described in Title II of the EBA Guidelines. The scores intend to capture the degree of the systemic negative impact that may be caused by a credit institution's insolvency or serious stress. In the second step, proceeding in accordance with Points 13 and 14 of the EBA Guidelines, a so-called Supplementary methodology is applied, which was developed in order to take account of the country-specific features of the domestic banking sector. The final scores that represent the systemic importance utilizing also optional indicators are produced on the basis of the so-called MNB methodology, which summarizes the Standard methodology and the Supplementary methodology.

2.1. Standard methodology

The Standard methodology, which is harmonised at EU level, comprises ten indicators that basically measure market share (Table 1). Based on the weighted average of these indicators, an individual score – between 1 and 10 000 basis points – representing the systemic importance is produced for each bank. Institutions reaching a score of at least 350 basis points at consolidated level are classified as systemically important. The EBA Guidelines permit the national competent or designated authority to modify this threshold – subject to detailed explanation – by ±75 basis points, if so justified by the specificities of the given Member State's banking sector. In the case of Hungary, by the decision of the Financial Stability Board, the specificities of the banking sector did not justify such modification.

Table 1: Indicators of the Standard methodology and their weights

Criterion	Indicators	Weight
Size	Total assets	25.00%
Importance	Value of domestic payment transactions	8.33%
	Private sector deposits from depositors in the EU	8.33%
	Private sector loans to recipients in the EU	8.33%
Complexity	Value of OTC derivatives	8.33%
	Cross-jurisdictional liabilities	8.33%
	Cross-jurisdictional claims	8.33%
Interconnectedness	Intra financial system liabilities	8.33%
	Intra financial system assets	8.33%
	Debt securities outstanding	8.33%

Source: EBA

[2] At present, none of the Hungarian investment firms were classified as systemically important by the MNB.

The EBA Guidelines stipulate which data of the FINREP reporting package shall be used for the calculation of the individual indicators of the Standard methodology. In the case of institutions not obliged to submit FINREP reports, the MNB uses the reports submitted for supervisory data provision.[3]

2.2. MNB methodology

The MNB improved the harmonised Standard methodology by applying the Supplementary methodology to reach a comprehensive coverage of systemic impacts. The MNB has chosen five from the optional indicators listed by the EBA Guidelines allowing a more precise identification taking account of the Hungarian specificities. Their inclusion ensures a more thorough assessment of the critical functions provided by the credit institutions and intra financial interconnectedness. During the selection of the additional indicators the lowest possible correlation of the given indicator with the standard indicators, the ensuring of consistence with the market share-based approach and the availability of data of proper quality and quantity played an outstanding role. In addition to stock type measurements one of the optional indicators included in the Supplementary methodology is related to transactional activity (value and number of payment transactions) and two of them are network centrality based measures.

The final scores of the Supplementary methodology are produced as the indicators' weighted average. Within the MNB methodology the optional indicators are included as part of a new, fifth criterion. The five criteria of the methodology have equal weights.

In line with Title III of the EBA Guidelines, the MNB decides on the list of institutions that are systemically important according to the Standard methodology, supplemented by further quantitative and qualitative assessment. The scores determined as the final result of the MNB methodology are the principal components; however the MNB's Financial Stability Board also takes into account qualitative, expert assessment in conformity with Title III of the EBA Guidelines.

[3] http://www.mnb.hu/felugyelet/adatszolgaltatas/hitelintezetek/2015-evi-adatszolgaltatas/21-2015-vi-29-mnb-rendelettel-modositott-51-2014-xii-9-mnb-rendelet-szerinti-adatszolgaltatas

Table 2: Indicators of the MNB methodology and their weights

	Criterion	Indicators	Weight
Standard methodology	**Size**	Total assets	**20%**
	Importance	Value of domestic payment transactions	**20%**
		Private sector deposits from depositors in the EU	
		Private sector loans to recipients in the EU	
	Complexity	Value of OTC derivatives	**20%**
		Cross-jurisdictional liabilities	
		Cross-jurisdictional claims	
	Interconnectedness	Intra financial system liabilities	**20%**
		Intra financial system assets	
		Debt securities outstanding	
Supplementary methodology	**Supplementary indicators**	Off-balance-sheet items (credit lines, guarantees)	**20%**
		Share in clearing and settlement system	
		Assets under custody	
		Interbank claims and/or liabilities (network analysis)	
		Market transaction volumes or values (network analysis)	

Source: MNB

3. Capital buffers for other systemically important financial institutions

In order to strengthen the shock absorbing capacity of the systemically important institutions, the MNB prescribed additional capital buffer as of 1 January 2017, in proportion to their systemic importance. The calibration of the additional capital buffer was based on the scores determining the systemic importance and specified in line with the MNB methodology. The statutory maximum of the capital buffer that can be required is 2 per cent of the total risk exposure. In line with that, the MNB set the capital buffer rate imposed on systemically important credit institutions between 2 per cent and 0.5 per cent.

Upon determining the values of the capital buffer rates for individual institutions, the MNB classified the institutions into homogeneous groups on the basis of their systemic importance. The groups were formulated using cluster analysis carried out at the level of criteria, indicators and scores according to the MNB methodology. The peer analysis of international control groups of important institutions offered further support in determining the composition of groups. With this method the MNB examined the consistency of the domestic calibration with the buffers applied to foreign institutions with similar relative importance. Finally, the MNB also utilized the so-called „equal expected impact" approach[4] applied by the Basel Committee on Banking Supervision (BCBS) in the calibration of the buffer rates for global systemically important institutions. According to this approach, the value of the buffer rates should equalize the expected external systemic cost caused by the bankruptcy or critical stress situation of different systemically important institutions.[5] As a result of the grouping of the institutions formed following the above examinations, the capital buffer rates increase proportionately to the scores of group members, with at least 0.5 percentage point steps for each group.

[4] BCBS (2013): Global systemically important banks: updated assessment methodology and the higher loss absorbency requirement. http://www.bis.org/publ/bcbs255.pdf

[5] Increasing the buffer rates reduces the probability of default of an important institution and adds to its resilience. If the bankruptcy of an institution entails significant external social cost, the expected cost may be reduced through the reduction of the probability of default, and may be offset with a lower external cost.