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Financial Risk&Regulation

Changing supervisory expectations: modified impairment calculations, liquidity stress tests for investment funds, and Pillar II capital requirement

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The current newsletter presents three important financial regulatory issues for which preparation and compliance will be a priority in the coming period. An important objective of the National Bank of Hungary's (MNB) expectations regarding impairment is to standardize the practices of the sector. Under ESMA's guidelines, fund managers are required to conduct regular liquidity stress tests on the funds they manage, where the protection of the interests of the redeeming and remaining investors is an important underlying principle. In addition, MNB has updated the ICAAP-ILAAP-BMA manual, which describes the prudential management of Funding for Growth Scheme (FGS) and Bond Funding for Growth Scheme (BGS) exposures.

MNB published its impairment expectations in its executive circular

In response to the changed situation due to the coronavirus and the introduced extraordinary measures, MNB amended its previous executive circular to adapt its prudential expectations regarding impairment under IFRS9 to the new circumstances. **The aim of MNB is to ensure there are no unjustified differences in the recognition of impairment between financial institutions for methodological reasons**. According to the Supervisory Authority, this objective will also be given special attention during on-site inspections and off-site supervision.

According to the amended circular, **in the case of short-term restructuring measures that bridge temporary payment difficulties (e.g. a payment moratorium alone),** its assessment as a factor indicating a significant increase in credit risk may be waived. This transitional period may last until the end of 2021 at the latest and may only be applied, if the financial difficulties of the debtor concerned and the restructuring are of a temporary nature.

In connection with this subject, the management circular presents in detail the good practice according to the MNB.

Nevertheless, credit institutions must continue to identify the risks of their exposures in a **timely, consistent and comparable** manner. In the uncertain situation caused by Covid-19, the practice proposed by MNB for financial institutions is to determine a portfolio-level **lump sum expected loss value** ("overlay"), in the event that their model used for a given portfolio is likely to underestimate the expected losses. According to MNB's proposal, this lump-sum expected loss value should be accounted for on individual levels, where the individual debtors of the sub-portfolio are reclassified to Stage 2 in equal proportions, regardless of their credit rating. The lump-sum expected loss value shall be accounted for in the same approval process as the group impairment level and shall be reviewed on a quarterly basis.

According to the **new minimum requirement**, the **level of impairment** (for the period up to 31 December 2021) at the level of the institution

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must exceed the amount calculated by the average impairment coverage at the end of 2019 projected to the stock data at the end of Q1 2020.

The Supervisory Authority's expectations regarding transparency remain strong, MNB highlights that the application of credit risk indicators and reclassifications due to increased risk, impairment levels and the calculation of estimated losses on portfolios not covered by the model should be presented in a transparent manner.

According to **MNB's impact assessment**, these steps could increase lending capacity in Hungary by up to HUF 1,000 billion and reduce the level of impairment in the credit institution sector by up to HUF 120 billion, thereby improving its capital position.

According to the amended management circular, the best practice identified by the MNB is to use MNB's Inflation Report and the macroeconomic forecasts in the circular (in its non-public annex) to take macroeconomic information into account. However, **it is also possible to use own or other external macroeconomic forecasts, subject to certain conditions**. In such cases, a brief economic justification must be attached to the forecasts about the underlying assumptions of the macroeconomic forecast prepared or used by the institution, and a comparison with MNB's forecasts must be made, justifying the differences between them. Macroeconomic forecasts and the supporting parameter data must be prepared in 3 scenarios, and weights must be determined for these scenarios by defining tolerance bands.

The central bank expects institutions to review their decision-making and control mechanisms for managing the effects of Covid-19, which MNB considers to be particularly important in the process of determining impairment. The recommended practice for this is to use the highest decision level, to prepare sufficiently detailed analyzes, documentation, calculations in accordance with the Covid-19 crisis characteristics, and in case of preparing assessments with multiple criterion to prepare impact analysis to confirm the application of the right criterion system.

MNB's new measures on impairment will remain in force until 31 December 2021 at the latest, but the National Bank may decide to revoke them earlier, assessing the current market situation.

The consideration of **IFRS9 impairment adjustments** in own funds has also changed with the CRR amendment adopted in June 2020, which we presented in our July 2020 newsletter.

ESMA's recommendations on liquidity stress testing of investment funds will enter into force shortly

The recommendations on liquidity stress tests (LSTs) issued by ESMA aim to ensure that investment funds perform LSTs on a uniform methodological basis at European level, which are also assessed by supervisors on the basis of uniform criteria. The recommendations also aim to improve the quality and consistency of LSTs and, in some cases, to increase their frequency. LST analyzes should cover both the asset and liability side and be evaluated comprehensively. LST has an important role to play in product development, crisis preparedness, emergency planning and even the subsequent use of additional liquidity management tools such as restricting the trading of investment units. The responsibilities of custodians also appear, as they need to check that the fund manager has documented procedures for the LST.

According to the guidelines, when developing LST models for undertakings for collective investment in transferable securities (UCITS) and alternative investment funds (AIF), **fund managers need to be aware of the risk factors affecting the liquidity of the investment fund** and develop scenarios. The results should be communicated to management and the observed indicators and risk management processes should be developed based on them.

ESMA considers it important to **establish appropriate policies** that include the role of the senior management and certain business units in relation to LST and liquidity management. It should also include internal reports, circumstances requiring escalation, and the frequency of performing and reviewing the LST. **Initial independent validation of LST models and related assumptions is expected**, scenarios and methods of assumed asset liquidations must be described.

The frequency of LST is normally quarterly, but at least annual. Determining the frequency is the responsibility of the fund manager, which should take into account factors such as the frequency of trading in the units, the level of liability-side risks, the liquidity of the assets, and the complexity of the trading strategy. In addition, an extraordinary LST should be performed, if significant risks are identified by the fund manager.

Scenarios can take into account past events, such as the global financial crisis of 2008-2010 or the European debt crisis of 2010-2012, while avoiding over-reliance on past data, overly optimistic assumptions and they may need to develop expert based approaches, as future stresses may differ from those experienced in the past. Great attention should be paid to low-probability but high-impact scenarios where potential pricing problems may arise for less liquid assets.

In order to **analyze the liquidity of assets**, the risk profile of the fund must be taken into account, as well as the important principle that the fund is managed for the benefit of both the redeeming and the remaining investors. The calculations should be based on past experience and expert risk analysis to estimate the

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expected higher volatility, the larger spread between bid and ask prices, and the longer time required for liquidation. Further analysis and action plans may be needed for funds investing in less liquid assets, such as real estate funds or mutual funds.

Assessing the liquidity risks of liabilities requires a qualitative and quantitative analysis of investors. In doing so, the investor category (e.g. institutional or retail), investor concentration, the geographical distribution of investors and the investor strategy (e.g. volatility strategies) should be examined. Additional liquidity risk may be posed by variation margins of derivatives, securities financing transactions, cash outflows related to borrowings, or needs for additional collaterals.

An important step is to summarize and interpret the stress results on the asset and liability side, as well as on individual funds. The output of a combined asset and liability LST can be a comparable indicator or score. When testing several funds, the relationships between them should be taken into account, for example, funds from similar investors or investing in similar assets are more likely to realize risks at the same time.

The liquidity stress test should be part of a complex risk management system, as proper technical support is required for their proper construction, be it market information, past observations, or simulation capacity. Appropriate methodological support and the existence of external controls are essential. It is therefore worthwhile to do this in a manner coordinated with other risk management and performance measurement tools, product development, value at risk (VaR), forward and ex-post analysis of return and risk, attribution of performance into explanatory factors and calculation of performance fees. We presented in more detail the latter two topics in our May 2020 newsletter.

MNB amended the ICAAP handbook in the light of monetary policy programs

In July 2020, the MNB expanded the ICAAP-ILAAP-BMA manual with prudential management of Funding for Growth Scheme (FGS) and Bond Funding for Growth Scheme (BGS) programs.

As part of the amendment, **the manual was supplemented with a capital requirement discount for loans disbursed under the FGS Go scheme**. The conditions of the discount are that the aggregate capital requirement reduction must remain below 1% of the total risk exposure amount (TREA) of Pillar 1 and can only be applied to the stock where the exposure with the given client related to the FGS Go scheme remains below 7% of institution's own funds the end of 2019. **The discount is 2% of the Pillar I risk-weighted exposure of the loans under the FGS Go.**

The **capital requirement discount** will be determined for the first time during the 2021 ICAAP review of the portion of the end-2020 stock that meets the relevant conditions. Subsequently, the calculation of the capital advantage would be based on the FGS Go portfolio disbursed up to the date of exhaustion of the budget, the reference date of the examination. **The discount is provided by MNB for a total of three years**.

The manual has also been expanded to include a **methodology for calculating the capital requirement for exposures of corporate BGS bonds**. MNB sets the credit risk capital requirement for securities issued under the BGS in the framework of ICAAP supervisions, that it does not expect a surplus in excess of the capital requirement based on the credit quality step under Article 122 of the CRR.

The **requirements for balloon / bullet transactions** within the risky portfolios will be slightly modified; working capital loans - with original maturity less than 3 years – will be an exception to the additional capital requirements.

In addition to the current extraordinary review, the MNB regularly publishes changes to the ICAAP-ILAAP-BMA manual on an annual basis. We wrote about the latest change affecting the inspections in 2020 in our February 2020 newsletter.

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