

Financial Risk & Regulation

Changes in supervisory expectations in the financial sector

Newsletter – February 2021

The MNB has published an updated version of the ICAAP-ILAAP-BMA handbook, the most important news are presented in our February newsletter. Among the changes are the green preferential capital requirement, the real estate financing project capital requirement, expected loss and the changes in the related supervisory benchmark rules, the changes affecting concentration risk of small banks, the topic of capital guidance and the benchmark model of the interest rate risk in the banking book. Finally, we present the other minor changes. We wrote about the previous changes of the ICAAP-ILAAP-BMA handbook in our [August 2020](#) (NHP and NKP exposures) and [February 2020](#) (annual review) newsletters. Experiences related to the MNB's comprehensive and other investigations were summarized in the [December 2020](#) newsletter.

Capital requirement reductions

The list of capital requirement reductions provided by the MNB was expanded during the revision of the ICAAP-ILAAP-BMA handbook in January 2021, with the supervisory aim to support green investments as widely as possible. Newly included in the handbook - among other things - the green preferential capital requirement for mortgage loans, the green corporate and municipal capital requirement discount and the capital requirement reduction related to DLT (Distributed Ledger Technology) projects. Due to their scope these topics will be presented in detail in our next monthly newsletter.

Supervisory real estate financing project benchmark model

The main objective of the MNB with the benchmark model is to assess the riskiness of portfolios according to the identified risk factors and to make the capital requirement levels comparable. It is emphasized in the handbook that the MNB can use the benchmark model in the case of large banks with

advanced methodology for comparison purposes and for determining the Pillar 2 capital requirement besides small banks without own methodology and data. In the new handbook the MNB has published which risk factors are taken into account separately in the PD (Probability of Default) of the expert model and in the benchmark LGD (Loss Given Default).

The PD of the expert model includes the type of the asset financed, the development phase, the DSCR (Debt-Service Coverage Ratio) and the size of the project as risk factors. The LGD of the benchmark is affected by liquid assets, LTV (Loan-to-Value Ratio), location and currency.

The MNB determines the size of the capital requirement using a corporate asset correlation with a uniform 5-year maturity parameter, while in the case of residential housing projects for sales purposes, the shorter term is 2.5 years. The MNB emphasizes that it pays special attention to the goodness of banking segmentation during the examination of the capital requirement of the real estate financing project segment.

Concentration risk of small banks

A new concentration risk methodology based on a simplified methodology has been published in the handbook for small banks. The reason for this was that in many cases small banks were unable to adapt the existing supervisory simulation methodology to measure the concentration risk of their portfolios. The methodology is based on a special weighted Herfindahl-Hirschman Index (weighted HHI) that seeks to differentiate between transactions with the same exposure but different credit risk, taking into account the collateral data and customer rating systems available to small banks, as well as the risk characteristics of specific segments. The calculation needs to be performed for exposures of performing clients aggregated at client group level, so that the HHI can measure the client group concentration. Exposures to the Hungarian State and to the parent bank can be eliminated from the calculation.

Based on the previously used simulation IRB based methodology, the MNB found almost a linear relationship between the corrected HHI and the granularity correction used in the benchmark model. The granularity correction expresses the relationship between the concentration and the capital requirement, where the multiplication of the granularity correction and the capital requirement based on the IRB formula constitutes the 2nd pillar capital requirement that also takes concentration into account. Therefore, MNB recommends the simplified linear relationship for small banks to monitor their concentration risks. The MNB emphasizes that this correction is only an approximate value, the exact value is determined during the ICAAP review. Below the value of 1.06 of the granularity correction it is not necessary to apply the multiplier. The quantitative and qualitative evaluation of concentration is shown in Table 1.

HHI _{korr}	Granularity correction
300	1,47
200	1,32
100	1,16
80	1,13
60	1,10
40	1,07
32	1,06
20	1,04
0	1,01

Table 1: The scale serves as a guide for portfolio concentration (green - no or low concentration; yellow - medium concentration; red - strong concentration)

New credit risk stress test in the P2G framework

From 2021, the MNB uses new models to estimate default and migration probabilities in the P2G (Capital Guidance) framework. In both the corporate and retail segments the new models are based on more detailed, client-level banking data that are covering a full economic cycle.

The portfolio-level approach is replaced by a client-level approach. In the corporate segment, besides the indebtedness, profitability and liquidity situation, the MNB also uses new, non-financial data, specific to the given company, such as the size of the company, the nature of the activity or the composition of the group of owners. To determine the transition probabilities, the model seeks to be in line with the IFRS9 impairment policy of domestic institutions with a uniform set of Stage rules.

The new methodology supports the possibility to separate companies by quality, as well as to estimate the PiT (Point-in-Time) PD relevant to the stress test, and to estimate the transition probabilities at the company level.

The client-level approach prevails also in the case of the retail segment, the new Stage migration model - unlike the previous - also takes into account transaction and client characteristics. Along these, so-called „rating“ categories are defined, thus better and lower quality clients can be separated. Separate time series regressions are used to estimate the migration probabilities of the categories between Stages, in which the MNB uses the macro variables that most determine the Stage movements. An important change is that mortgage loans and consumer loans have been separated in the modeling due to their different characteristics. The level of impairment that is expected on the stress trajectory is calculated using the following components: PDs derived from changes in migration probabilities, separately stressed LGDs, and the maturity of the given transaction.

Liquidity risks

The MNB has modified Annexes 10, 11 and 12 at several points, which will be given special emphasis during the supervisory inspections. During the examinations the MNB can request the composition of liquid assets, including the classification logic, valuation and steps of encumbrance. The template requests in detail the free stock, the encumbrance and the stocks posted and received due to repos. The MNB draws attention to the fact that the liquidity and funding ratios requirements must be met constantly, not only on reporting dates. If it is suspected that an institution does not meet the requirements based on other data provided to MNB, the MNB will examine this as a matter with priority.

The MNB has refined the list of liquidity risky deposits at several points. The MNB extends the excess liquidity requirement of large depositors to the NSFR after the LCR. Individual priced deposits may also fall into the riskier category of deposits, as some large companies manage their cash holdings much in their liquidity management much more actively, than the usual corporate behavior. For this reason, the 40% outflow factor does not necessarily cover the risks. In addition, deposits placed under an agent's mandate are considered risky, whose behavior is also reminds of the behavior of financial clients. Therefore banks should strive to identify risky liabilities as accurately as possible.

In addition, the concept of step-in-risk appears, which means that the bank provides liquidity assistance to an entity belonging to the broadly defined banking group, primarily for reputational reasons. The most important case of this is the liquidity risk of investment funds linked to the bank, in which the bank has to assess the liquidity risks that may arise in a 30-day period, taking into account risk mitigating factors such as closed-ended nature or longer redemption period. An important exception is that the risks must be calculated on a fund-by-fund basis, as one's favorable liquidity position cannot be used up for the other's lack of liquidity. On a similar topic, we wrote about the liquidity stress test of investment funds required by ESMA in our [August 2020 newsletter](#).

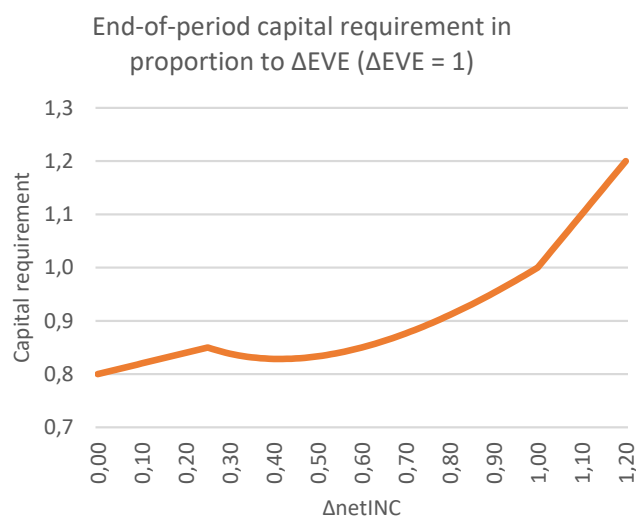
Interest rate risk in the banking book

In determining the capital requirement for interest rate risk in the 2nd pillar, the MNB continues to rely on the volatility of the economic value of capital/equity (ΔEVE), but creates the net income sensitivity (ΔnetINC), in which net interest income (ΔNII) is supplemented by fair value volatility and a stressed net interest income indicator calculated on the basis of previous years.

The fair value volatility covers the impact on capital of the revaluation of fairly valued securities and interest rate derivatives. In practice this means that the revaluation effect of securities registered in the FVOCI and FVTPL categories, in particular government bonds, are part of the earnings sensitivity, as it directly affects the regulatory capital. The MNB also takes into account the fair value volatility of interest rate positions in this indicator, but excludes from it those derivative transactions for hedging purposes that are against securities, other assets and liabilities carried at amortized cost.

The stressed net interest income indicator is based on net interest income data of the previous 3 years. However, for prudential reasons, the value is taken into account at a stressed value at 99% confidence level and is multiplied by 0.25 as an additional factor.

As before, the calculation of the end-of-period capital requirement is still based on the weighted average of the two interest rate risk indicators, the ΔEVE , and the new ΔnetINC , but the weighting is no longer based on gaps but on the ratio of the two indicators. The end-of-period capital requirement is determined in such a way that in case of low result sensitivity it corresponds to approximately 80-85% of ΔEVE , but in case of high ΔnetINC the latter determines the capital requirement as shown in Figure 1. The calculation of the effective capital requirement is still based on the average and standard deviation of the last 12 months.



In connection with the calculation of interest rate risk sensitivities, the MNB emphasizes the importance of defining prepayment models and interest rate floors, and also provides specific guidelines for segmentation and the examination of the relationship between interest rates and prepayment rates.

Important element of the supervisory assessment of interest rate risk are the 9R1 and 9R2 reports, the completion of these reports has also been modified by [MNB Decree 42/2020. \(XI. 19.\)](#). The changes include the methodology for reporting repricing periods, average interest rates and spreads.

Other changes

Credit risk

In the case of credit risk, in addition to the issues already mentioned above, the risk of securitization has also been reviewed. Institutions using the internal or external rating approach need to specify the maturity of the tranche as an additional parameter. Two methods can be used to determine these tranches. One method is the so-called WAM method, in which the maturity can be determined as the weighted average of the contractual payments' maturity due in the tranche. Alternatively, maturity can be determined by the legally fixed final maturity of the tranche.

Market risk

Regarding market risks, the January edition of the ICAAP-ILAAP-BMA handbook does not contain any significant change compared to the previous version of June 2020, however adds to the calculation of net open foreign exchange positions that structural foreign exchange positions as defined in Article 352 of CRR should be taken into account in accordance with EBA / GL / 2020/09 ([Guidelines on structural FX](#)). The purpose of this guideline is that institutions that also have a foreign currency-denominated RWA and have decided to take structural foreign exchange positions in order to stabilize capital adequacy ratios, can be exempted from the capital requirement for these foreign exchange positions.

Operational risk

With regard to operational risk, the Basel Committee's modifications published in December 2017 are expected to be implemented in CRR3 at EU level. Considering this, the MNB expects institutions within the ICAAP framework to quantify the capital requirement according to the SMA (Standardized Measurement Approach) methodology on a regular basis, at least once a year, according to the currently known rules, and the MNB expects all institutions to compare the calculated SMA value with the current capital requirement level. If the value calculated using the SMA method would be higher than the 2nd pillar capital requirement, the MNB expects a detailed justification for the difference or the difference to be taken into account in the 2nd pillar capital number, or the MNB may prescribe an additional capital requirement in order to be the risks fully covered.

Rules applicable to investment firms

During the revision of the ICAAP-ILAAP-BMA handbook, the MNB also touched upon the rules applicable to investment firms. As a result, the current SREP questionnaires (Annexes 8a, 8b, 8c) examine in more detail - among others - the business model, strategy, profitability, control functions, risk management and internal capital calculation and liquidity issues of investment firms. In addition, investment firms must be prepared for the new requirements of [Directive 2019/2034 /EU](#) and [Regulation 2019/2033/EU](#) (the regulation enters into force 26 June 2021).

Contacts:

Ágnes Rakó Partner

M: +36 70 370 1792
E: agnes.rako@kpmg.hu

Péter Szalai Director

M: +36 70 370 1739
E: peter.szalai@kpmg.hu

Gergő Wieder Senior Manager

M: +36 70 333 1471
E: gergo.wieder@kpmg.hu

József Soltész Manager

M: +36 70 370 1766
E: jozsef.soltesz@kpmg.hu

KPMG.hu



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