

Financial Risk & Regulation

The MNB's new recommendation on taking, measuring and managing credit risk

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After two years, the Hungarian National Bank (MNB) renewed its recommendation on the acceptance, measurement, management and control of credit risk, which defines a number of new expectations for credit institutions. In addition to addressing new challenges such as the risks posed by climate change or the exploitation of the opportunities offered by digitalisation, the recommendation sets stricter requirements for the use of external service providers in both collateral valuation and debt collection. By demanding the development of a comprehensive credit risk culture, the Supervisor is steering market participants towards a more flexible operation that can better adapt to changes in the economy. In the recommendation, MNB implemented the remaining part of the European Banking Authority's Loan Origination and Monitoring Guideline (EBA / GL / 2020/06).

Comprehensive credit risk culture and more emphasis on the development of appropriate expertise

In line with EBA's guidelines, MNB now expects market participants to develop a comprehensive credit risk culture in addition to regulations and policies. A credit risk culture that is known to employees involved in assuming, managing and controlling credit risk, and is in accordance with other strategic and risk management rules and policies. The organization's members should be accountable for complying with the credit risk culture. According to MNB, the communication of the institution's credit risk culture must be ensured in the form of regular trainings in addition to the appropriate documentation.

In relation to the credit risk culture, it is required that the organizational structure of the areas affected by credit risk management are regularly reviewed, and MNB places greater emphasis on appropriate expertise, emphasizing the importance of ensuring the adequacy of data and information provided

by customers, partners or issuers. The credit risk culture is also to be designed integrating assessment and management of risks associated with ESG and money laundering and terrorism financing.

Stricter rules will apply to the use of external service providers

MNB sets expectations regarding the selection process of external debt managers/ collectors and emphasizes that in such orders, institutions must pay due attention to the risks arising from the excessive use of a given service provider.

According to the recommendation, the preliminary risk assessment and due diligence tasks should be performed by the Compliance function if the organization uses an external debt manager/ collector. In this case, the risk assessment of the service provider must be reviewed annually, regardless of whether the outsourced function is critical or important. The Supervisor also sets requirements for the content of disclosure obligations related to agreements with such external service providers.

Like in the case of debt management/collection, the recommendation sets stricter requirements for external collateral evaluators as well. Institutions are required to evaluate the activities of them on a regular basis (preferably annually), the results of which should be reported to the governing body. The results of the evaluation need to be communicated to the relevant departments and taken into account in further cooperation.

The concentration and the management of conflicts of interest is highly important in the valuation of collateral

The recommendation stipulates that the decision preparation process should include the evaluation of the collateral, the legal requirements to be enforced for the given collateral and the examination of the fulfilment of the requirements arising from the internal regulations of the financial institution. The use of proportional collateral allocation is required, so if a collateral is included in more than one transaction, the collateral value considered as a risk mitigating factor may not exceed the actual collateral value of the given collateral.

In accordance with EBA's Guidelines, MNB expects financial institutions to ensure independence and a high level of professionalism in relation to the valuation of collateral and appraisers (both external and internal appraisers). Thus, MNB considers it a good practice to use effective tools in the selection, remuneration and monitoring of those dealing with the valuation of collaterals. The recommendation sets out the mandatory elements of valuation. Furthermore it expects the management of concentration risk arising from valuations, and MNB is highlighting the rotation of appraisers or the limitation of successive valuations by the same appraiser as a solution for such risk management.

Cases of performing extraordinary revaluations, during which a full valuation is required, are also defined. The Supervisor considers it good practice for institutions to document the employees performing valuations by type of collateral and encourages institutions to exercise greater caution in order to avoid potential conflicts of interest.

A more pronounced consideration of risk costs is expected in pricing

The recommendation sets out minimum content requirements for the pricing policy expected of financial institutions, such as customer and transaction type guidelines and the pricing of promotional transactions. Institutions shall take into account in pricing the costs relating to the given exposure till maturity or repricing, as well as all relevant costs allocated to that exposure, such as operating costs. MNB requires the financial institutions to establish appropriate processes to ensure that the price determined during the

decision-making process reflects the risks arising from a given exposure. Furthermore, to filter out exposures whose actual cost exceeds the expected return through price monitoring, as well as to provide feedback to both the business and to the risk-taking and risk management areas.

Risks related to climate change need to be integrated into the lending process

MNB has previously implemented many of the EBA's expectations in its 5/2021 "Green" Recommendation, which we wrote about in detail in our [April newsletter](#). Thus, most of the new obligations for the risk management framework and credit risk management have already been laid out before.

This for example includes examining whether a financing project is environmentally sustainable and conducting a climate change and environmental risk assessment of customers before taking a risk. Assessing how climate and environmental risks affect a borrower's probability of default (PD) and average loss given default (LGD) is a particular challenge when assessing credit risk.

Different evaluation criteria will need to be defined for specific project loans

As in the past, MNB expects financial institutions to take into account the specific nature and risk characteristics of customer, partner, issuer and transaction types when preparing credit decisions. The new recommendation, sets out different criteria and valuation practices for creditworthiness, solvency and collateral valuation for retail, micro and small enterprises, furthermore medium and large corporates. Also, in accordance with EBA's guidelines, MNB expects the development of specific assessment practices regarding special types of transactions and credit exposures, including the financing of commercial real estate, real estate development, shipping, project and highly leveraged transactions. MNB sets separate, individual evaluation criteria for the above listed types of transactions.

MNB expects financial institutions to define in their internal regulations the highly leveraged transactions and specify the risk-taking process and procedures related to these transactions, as well as the risk identification, measurement, monitoring and control requirements that may be attached to them. Besides that, in line with the above strict requirements, MNB only recommends to undertake a limited amount of highly leveraged transactions.

MNB expects a higher level of digitization from credit institutions

As part of the new recommendation, MNB expects the establishment and operation of an early warning system capable of detecting an increase in credit risk, taking into account the



principle of proportionality. In this regard, financial institutions are required to define in their internal regulations, *inter alia*, the indicators and the criteria used for the signal, the frequency of assessments and the due date of any special procedure. MNB emphasizes the importance of monitoring activities, especially when the organization detects a larger increase in credit risk for a given customer on a transaction or on a portfolio basis at the early warning system.

The management of risks related to technology-based innovations is also an expectation in MNB's new recommendation, such as the possible risks of statistically based collateral valuation. In connection with the documentation of the applied models MNB expects among others the recording of the methodology, data, assumptions, limitations of the model, as well as the measures taken to achieve proper operation and avoid biases. It is important that the management body is aware of the use of technological innovations and their possible limitations. For financial models to work, financial institutions need to have the right IT systems, processes, and resources.

MNB also expects the operation of a sufficiently detailed data infrastructure to ensure the information, continuity, integrity and security of all transactions, including exposures and collateral, throughout the term. Adequate data infrastructure

and IT background provide support for credit risk taking, measurement, management and control. MNB emphasizes that the institution's IT processes and systems must be suitable, among other things, for the complete recording and aggregation of all transactions based on certain categories and criteria. It is also important that these IT processes and systems are proportionate to the complexity and volume of transactions that give rise to credit risk. Changes and modifications require regular review.

New aspects will also need to be incorporated during the client and counterparty rating process

Regarding the client and counterparty rating process, the new recommendation also emphasizes the enforcement of the requirement for responsible lending and the minimization of the risk of internal and external fraud related to credit risk, as well as the identification and assessment of customer group-level risks in customer group financing. MNB also expects a regular, documented reassessment of the client and counterparty rating process, which ensures that institutions only assume credit risk exposure to a customer, counterparty or issuer that is expected to be able to meet the terms of the contract.

Additional supervisory requirements

In connection with the restructuring of receivables, MNB expects that the specific requirements for the restructuring of retail exposures are documented in the internal regulations of financial institutions. This includes portfolios, segments and standardized restructuring measures, as well as the process, procedures, responsibilities and competencies for their application.

In credit risk decision making, financial institutions shall have in place internal policies, processes, procedures and controls to maintain objectivity and avoid conflicts of interest. The recommendation also emphasizes that, in the case of riskier or higher-volume transactions, a credit decision at least at the commission level is required, regardless of the type of customer or transaction.

With regards to remuneration, MNB expects institutions to consider the inclusion of credit quality criteria in the variable component of remuneration of employees involved in credit risk-taking. The recommendation also draws attention to the establishment and application of remuneration practices in accordance with the relevant legal regulations and MNB's remuneration recommendations, which policy should be in line with the financial institution's credit risk appetite and credit risk culture, and avoids excessive risk-taking or risk-taking that causes harm to the clients.

The requirements of the current and previous MNB recommendations encourage institutions to review their lending processes on a regular and documented basis, which facilitates the implementation of innovative solutions, the selection of appropriate external service providers and the efficient and proper operation of the financial institutions' most important process.

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