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Financial Risk&Regulation

Changes in supervisory's ICAAP-ILAAP-BMA handbook

Newsletter – January 2022

The MNB has published its requirements and methodologies for the 2022 ICAAP, ILAAP, BMA reviews as part of the standard annual update. Requirements for the portfolios of the NKP bonds and green loans have changed in line with their increasing role. In addition, the MNB refined the classic elements of the ICAAP, thus changing the interest rate risk reporting and benchmark model, expectations for the risky portfolios, operational risk and stress testing, The section of the market and counterparty risk of the Handbook have been updated in parallel with application of the CCR2. During the 2022 ICAAP and ILAAP revision, the MNB already expects the new requirements to be applied.

Capital requirements of the NKP bonds

The MNB amended the calculation of the credit risk capital requirement for bonds issued under the Bond Funding for Growth Scheme (NKP). If the institution defines the risk weights in Pillar 1 on the basis of the assessments of the rating agencies Scope and Euler Hermes (which already part of the Scope Rating Group), the MNB will not apply a surplus in Pillar 2. However, if the institution defines risk weights on the basis of assessment of an another rating agency, the MNB determines the Pillar 2 capital requirement on the basis of its own methodology, with the restriction that it may not be higher than the capital requirement calculated on the basis of the ratings on the MNB's website.

Counterparty credit risk – ICAAP review

In connection with the counterparty risk, the Supervisory Authority emphasizes that the new standard methodology (SA-CCR) is more risk-sensitive than mark-to-market method, which was widely used in the domestic financial sector previously, and was withdrawn by the CRR2, thus the SA-CCR results in own funds requirements that better reflect the risks associated with institutions' derivatives.

It follows from the above, the institution should consider whether the level of risk justifies a more complex and conservative capital calculation methodology compared to Pillar 1 when calculating the Pillar 2 capital requirement. In general cases, the MNB also considers the SA-CCR methodology to be sufficiently risk-sensitive for the calculation of the Pillar 2 capital requirement. However, for institutions using the original exposure method, the MNB recommends using more conservative values in Pillar 2 than the multipliers specified in Article 282 of CRR to determine potential future exposure.

Green preferential capital requirement

In the updated Handbook the MNB supplemented and harmonized the conditions for the application of the housing, corporate and municipal green preferential capital requirement, as a result the total amount of the corporate and municipal green preferential capital requirements and the housing

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green preferential capital requirement may not exceed the 1.5% of the credit institution total risk exposure amount (TREA) during the ICAAP reviews initiated in or after 2022.

Further change is that MNB differentiated the preferential capital requirements for the green corporate and municipal exposure. According to this requirement, the preferential rate may be 5% of the total gross exposure of the existing relevant portfolio or 7% in case of compliance with the EU Taxonomy, provided that the level of the capital requirement in Pillar 2, which was preferentially reduced by the NHP GO, cannot fall below 0.

In order to take account the green corporate and municipal capital requirement preferential the MNB expects the application of the green flag to distinguish the 5% or 7% in credit analytics.

The MNB supplemented the reporting deadline in connection with green financing.

Operational risk

The MNB requires the data collection threshold related to the operational risks (risk events) to be determined in proportion to the size of the institutions.

The MNB amended and supplemented the requirements related to the collection of loss data at several points:

- It has identified the events which do not have a direct impact on capital and earnings but require risk mitigation measures and data collection is recommended. Such events may include lost profits, near misses and non-quantifiable claims.
- It stipulated that the classification practice of events affecting several business lines - the allocation method between business lines or their classification as a total banking event - should be provided for in the internal policies in force.
- It also expects the returns to be categorized, as well as the losses, according to the sources identified by the institution.
- The Supervisory Authority has specified the frequency of the participation in appropriate training by employees involved in loss data collection, i.e. at least once a year, the relevant employees must receive training on the identification of operational risks and the data collection processes.
- The control mechanisms established to ensure the quality of the collected data should include the monitoring of late recording of losses and the examination of consistency between the dates of detection, recording, occurrence and accounting of the loss event.
- The frequency of identification of realized losses in the general ledger or analytical accounting records, which is part of the control mechanism, is also regulated, according to which it must be done regularly, but at least quarterly, by the method of bilateral reconciliation. In addition, the range of accounts included in the audit should be reviewed annually to identify newly created accounts with operational risk losses.
- It formulated expectations regarding the content of management reports that losses should be presented both in aggregate and itemized for the largest individual losses, together with the associated risk mitigation measures.

A new requirement for the product inventory, which is the basis for the identification and assessment of business risks, is its annual review, the presentation of the results and the action plan to the management.

Market risk

A larger institution with a significant trading portfolio and more complex positions is still expected to develop an advanced (VaR-based) internal methodology for calculating the capital requirement for market risks. Taking into account regulatory developments (Fundamental Review of Trading Book – FRTB), the application of the expected shortfall (ES) model is also acceptable. By the revision of the Handbook, the MNB expects institutions to comply with EBA/GL/2021/07 on the use of input data in the risk measurement model from 2022 onwards.

Interest rate risk in the banking book

Reinforcing its previous practices and communications, the MNB is drawing new attention to the need to take interest rate floors into account in its calculations, especially in the case of retail deposit products. It also expects the regular calculation and reporting of supervisory benchmark tests based on ± 200 basis points and based on 6 EBA scenarios and, if the limits are exceeded, to be reported within 5 working days, detailing the reason for the exceedance and the steps planned to eliminate it. It is also expected, in particular for large institutions, that appropriate risk measurement and management processes be adapted to net interest income sensitivity (dNII).

A methodological fine-tuning is that the revaluation of positions that are accounted at fair value and hedged should not be taken into account when examining earnings sensitivity. In addition, the MNB emphasized that institutions should use deal-specific interest rates, which includes spreads, when calculating net interest income.

When calculating the benchmark IRRBB capital requirement, the MNB clarified that changes in the fair value of positions valued and hedged should not be taken into account in the earnings indicator. It further clarified that in addition to securities and

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interest rate derivative positions, receivables and other instruments should be taken into account in the calculation of fair value sensitivity if they are measured at fair value.

The development of interest rate risk regulations is also underway at EU level, with the EBA's consultation package published on 2 December 2021, which contains significant changes. We plan to summarize this in our newsletter of next month.

New reporting requirements for the interest rate risk

Although not part of the ICAAP Handbook, it is closely related to the supervisory practice concerning the IRRBB that in November 2021 the MNB expanded its interest rate risk in banking book reporting package (MNB Decree 55/2021). Banks have so far had to fill in the tables with codes 9R1 and 9R2, but the reporting obligation is extended by four more tables (9R3, 9R4, 9R51, 9R52).

9R1	Interest rate risk data
9R2	Interest rate risk profit
9R3 (new)	Supervisory outlier tests
9R4 (new)	Fair value positions
9R51 (new)	Hedge accounting in a credit institution's accounting practices
9R52 (new)	Hedged and hedging positions involved in hedge accounting relationships

The results of the yield curve scenarios according to table 9R2 are also included in table 9R3, in which banks report the results of the supervisory outliers test to the supervisory authoritiy.

In the table 9R4 banks should include their balance sheet positions that are relevant to interest rate risk and measured at fair value. In Table 9R4, the transaction interest rate, interest rate spread and current notional amounts for the positions shall be summarized and reported along the specified grouping columns (e.g. product group, customer segment, revaluation data, etc.).

The reporting package includes the tables 9R51 and 9R52, in which banks are required to disclose their hedging practices for interest rate risk. Table 9R51 provides the Supervisory Authority with qualitative information on whether the bank applies hedge accounting and what the purpose of the hedging is, what risks are covered by which transactions. Table 9R52 will provide data on the hedging positions of banks, with a breakdown of hedged items and hedging instruments involved in hedging relationships. Each legs of the derivative must be shown on separate lines.

Stress tests

The MNB states that in addition to EBA/GL/2018/04 (Guideline on institutions' stress testing) published on 19 July 2018, it considers the latest EU-Wide Stress Test methodological description, published on 29 January 2021 by EBA, to be relevant to its investigations.

In addition to the above, the Supervisory Authority has set new expectations for the internal stress test of institutions:

- the stress test must cover a minimum of two years after the current period (minimum time horizon required),
- the calculations must be carried out without the planned capital increase,
- the level of leverage that reflects the impact of the economic shock should be determined,
- during the reverse stress test, it is necessary to stress at least the PD parameter so that it has an effect on the institution's capital adequacy, at least through impairment and changes in RWA.
- Large and complex institutions should examine the impact of a shift in the yield curve on the cost of credit risk for each business segment.

Supervisory Capital Guidance (P2G) and SREP Capital Requirement

The amendment to the Handbook provides an opportunity for the MNB to take into account qualitative aspects from the experience of the ongoing supervision of a given institution when quantifying Capital Guidance.

When determining the SREP capital requirement, the Supervisor aims to reflect the non-quantifiable factors and the supervisory experience already mentioned in the previous paragraph, thus strengthening the relationship between the SREP capital requirement and the SREP viability score. The means of this is that the MNB may modify the capital requirement under SREP determined by quantitative methods on the basis of qualitative considerations.

Risky portfolios

Clarification regarding the calculation of additional capital requirement regarding risky portfolios that the add-on should also be formed for the off-balance sheet part of exposures classified as risky.

Residential real estate development project loans for sale have been exempted from the additional capital requirement for balloon / bullet transactions. A further change is that it is not possible to deviate from the 50% additional capital requirement under the general rule, this previous exemption has been revoked.

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Regarding loan disbursements that do not comply with the rules of the Payment-to-Income (JTM) Regulation (without a positive KHR rating), the regulation has been supplemented according to the additional capital requirement must no longer be based on a predetermined risk weight, but in such a way that the total gross exposure is covered by own funds. That is, the amount of the capital requirement in Pillar 2 and the impairment should reach the value of the total gross exposure. If it is not fulfilled, the institution shall calculate the difference between the gross exposure and the amount of the capital requirement in Pillar 2 and impairment under high-risk portfolios. This rule also applies to refinancing transactions, regularly prolongated revolving loans or other loans.

Liquidity risks

The MNB expands the assessment and monitoring of liquidity risks with a new indicator, the maturity mismatch, which the MNB itself calculates from table C_66. In this connection to it, the institutions are responsible for ensuring the appropriate data quality and developing their own methodology. The indicator used by the MNB is based on the initial amount of balancing capacity, which is modified by certain items. It then takes their minimum values into account for 3 different time periods.

Previous changes of the Handbook

The MNB regularly updates the ICAAP and ILAAP requirements in line with legal and sector developments. Changes in recent years have also been covered in our February 2021, August 2020, and February 2020 newsletters.

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