Financial Risk&Regulation

Changes in MNB ICAAP-ILAAP-BMA methodology manuals

Newsletter – March 2023

In December 2022, the National Bank of Hungary (MNB) according to the regular practice reviewed its expectations and methodologies for the ICAAP[1] and ILAAP[2] processes and their supervisory review, in addition for BMA[3] and issued an updated manual for supervised institutions. Following the annual update by MNB, KPMG experts have been analyzing and presenting the main changes for the fourth year now. The summaries of previous manuals are included in newsletters at the end of this summary, and we have also written about understanding supervisory expectations regarding ICAAP and ILAAP in our September 2021 newsletter. In addition to the annual reviews, the MNB also modified the manual in 2020 after an extraordinary review. Our August 2020 newsletter summarized the changing supervisory expectations regarding this modification.

Overview

Among the significant changes, it is worth mentioning the methodology for determining the banking book interest rate risk capital requirements, the measures for preferential capital requirements for green loans, the expectations related to settlement/delivery risk, supervisory expectations for internal stress tests, as well as the supplement and clarification of requirements for the internal audit of the ICAAP framework. The Manual has also been expanded at several points with determining the methodology for the supervisory additional required capital and the capital guidance concerning the risk of excessive leverage, as well as the implementation of domestic and international regulations, guidelines and methodological notes. The MNB will proceed in line with the updated Manual during the 2023 reviews.

Interest rate risk in the banking book

In accordance with the amended EBA Guidelines[4], the MNB has amended the parts of the Manual on non-trading book interest rate risk management at several points. In our previous newsletter, we already summarized the latest elements of the Guidelines, and now we analyze the most important aspects of the domestic regulation.

1. **Supervisory outlier tests (SOT)** regarding the economic value of equity (EVE) and a new outlier test for net interest income (NII).

The supervisory outlier tests used in addition to the banks' internal stress tests were included in a separate EBA material[5]. The EVE SOT contains only minor changes compared to the previous outlier test requirements. Accordingly, the quotient of the largest negative impact of EVE calculated in the six EBA scenarios and T1 capital cannot exceed the 15% threshold. The previous limit of 20% on own funds was phased out in accordance with the changes in the regulations.

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1 Internal Capital Adequacy Assessment Process

2 Internal Liquidity Adequacy Assessment Process

3 Business Model Analysis

4 Guidelines on IRRBB and CSRBB

5 Final draft RTS on IRRBB supervisory outlier tests

The net interest income sensitivity was also limited in the framework of the supervisory outlier test, similarly to EVE. The NII risk of the two parallel yield curve scenarios is determined assuming a one-year modelling period and a constant balance sheet. Based on the new expectations, the ratio of the larger loss occurring in the two scenarios and the bank's T1 capital cannot exceed 2.5%. The definition of NII used in the supervisory tests, after a longer consultation, finally became the financial result in the narrower sense, which does not include fair value effects, in order to make it easier to compare between banks.

A change to be highlighted is that in the yield curve scenarios applied to the HUF currency, instead of the shock rate of 250/350/160 basis points in the previous Manuals, the rates of 300/450/200 basis points recommended by the EBA will be applied starting in 2023:

Intensities of the standard HUF currency interest rate shock

Parallel	Short	Long
3,00%	4,50%	2,00%

source: MNB ICAAP-ILAAP-BMA Manual

2. Changes in IRRBB and CSRBB

The MNB considers international guidelines to be the guiding principles for the issue of credit spread risk arising from non-traiding book activities (CSRBB) and does not go into detailed regulations.

When calculating the NII sensitivity, the expected positive net interest income can be taken into account as a compensating effect. However, the MNB has now reduced the length of the look-back period from three years to one year, therefore the average that can be taken into account must be calculated. Thus, the potential downward trend in banks' net interest income indirectly leads to an earlier increase in capital requirements.

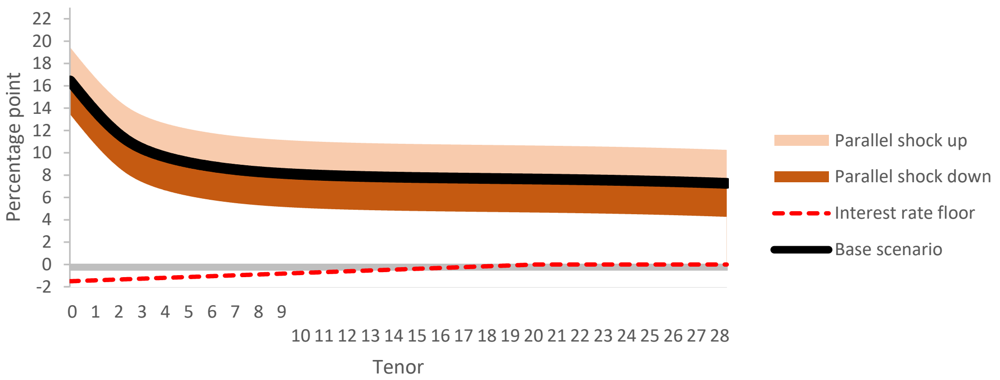
3. Interest rate floor

In addition to the already mentioned change in HUF shock rates, the interest rate floor applied to the shocked spot and forward yield curves have also changed.

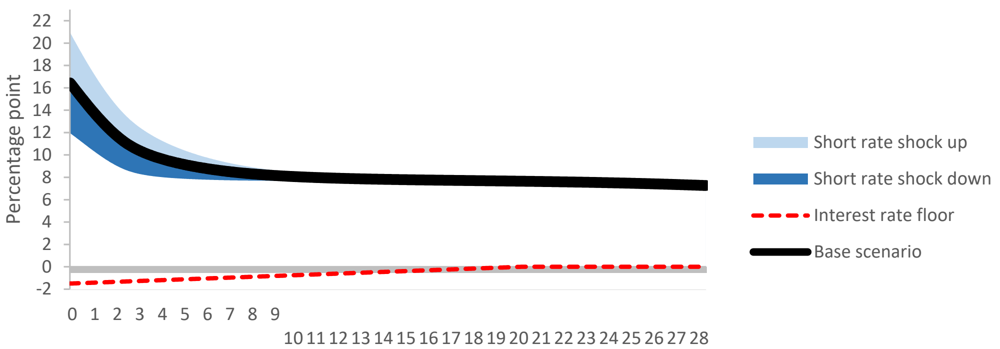
The level of the floor was set at -1.5% at the overnight point of the MNB spot zero coupon yield curve and at 0% at the points corresponding to maturities of 20 years or longer, and the lowest permissible level of the intermediate points is determined by linear interpolation. In the previous version, the floor at the overnight point was -1.0%.

However, in the current interest rate environment, the interest rate floor has no effect on the applied spot and forward yield curves, neither in the case of HUF, nor EUR, nor USD.

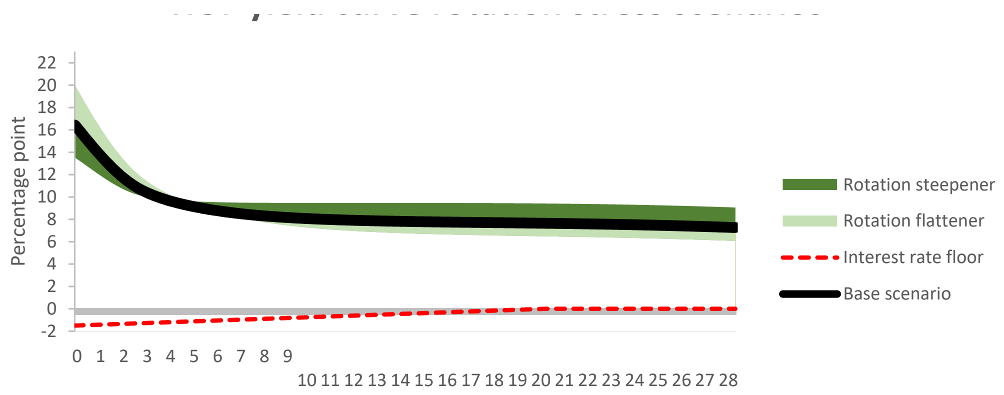
HUF parallel yield curve shift stress scenarios



HUF short rate shift stress scenarios



HUF yield curve rotation stress scenarios



source: MNB ICAAP-ILAAP-BMA Manual

4. Regulations regarding the modelling of core deposit portfolio

Essential elements have also been modified in the sight deposit modelling. First, in the benchmark model of the MNB, large individual deposits placed by financial partners cannot be considered part of the core portfolio.

Second, an important new element in the sight deposit modelling is the segmentation of transactional and non-transactional retail accounts.

Regarding the above changes, the MNB determines a maximum ratio and maximum duration within sight deposits:

Segment	Maximum ratio of the core portfolio within the total portfolio of non-maturing products	Maximum average remaining maturity
Retail / transactional	90%	5,0 years
Retail / non-transactional	70%	4,5 years
Corporate	50%	4,0 years

source: MNB ICAAP-ILAAP-BMA Manual

The replicating approach divides the core part of the sight deposit stock into the priority tenors, while the non-core part of the deposits goes into the 1-month category. In previous years, the MNB recommended setting the weight of the investments corresponding to each yield curve point by maximizing the ratio of the margin and margin deviation between the replicating portfolio and the deposit interest. This year, an addition had been made, according to which the bank models should include at least a return point within two years and beyond two years, thereby directing risk management in the direction of a laddered portfolio approach that ensures greater liquidity.

Preferential capital requirements for green loans

The MNB has only amended the conditions for the application of the preferential capital requirement discount for green housing loans during the Manual revision, as a result, in the ICAAP reviews started in 2023 or later, the amount of the discount will be determined not only based on the energy efficiency category and the distinction between construction/renovation, but also on the separation of new and used homes for purchase, as well as a separate category for the purchase and renovation of used homes. In addition, newly renovated residential buildings before purchase appears as a new category. The changes resulted in both favorable and stricter modifications by transforming the classifications. The changes are summarized in the table below.

<table>
<tr><th colspan="3">2022</th><th colspan="4">2023</th></tr>
<tr><th>Energy efficiency category</th><th>BB</th><th>AA</th><th>Energy efficiency category</th><th colspan="2">BB</th><th>AA</th></tr>
<tr><td></td><td></td><td></td><td>Change in conditions</td><td>Before 09.06.2022
90 kWh/m2/yr</td><td>After 09.06.2022
80 kWh/m2/yr</td><td></td></tr>
<tr><td rowspan="3">Construction or purchase of residential buildings</td><td rowspan="3">5%</td><td rowspan="3">7%</td><td>Construction or purchase of new residential buildings</td><td colspan="2">5%</td><td>7%</td></tr>
<tr><td>Purchase of used residential buildings</td><td colspan="2">5%</td><td>5%</td></tr>
<tr><td>Purchase of used residential building after renovation</td><td colspan="2">5%</td><td>7%</td></tr>
<tr><td>Renovation or modernisation</td><td>5%</td><td>5%</td><td>Renovation or modernisation</td><td colspan="2">5%</td><td>7%</td></tr>
</table>

source: compiled by the author

Settlement/delivery risk

With regard to settlement risk, during the ICAAP review, the expectations regarding the calculation of the additional own funds requirement were somewhat eased. In the previous version of the Manual, for capital requirement calculations, the MNB considered the maximum daily value of the previous year as the effective capital requirement, instead of the value calculated for the current date (e.g. end of month or quarter). The MNB however still deem a stricter procedure proper than the approach used in Pillar I, therefore the weights determined in CRR are still applied by the MNB under stricter conditions.

The internal audit of the ICAAP framework

Regarding expectations for the internal audit of the framework, some tightening can be observed, as previously, individual reviews were conducted with a frequency corresponding to the risk weight solely for high or significant and medium risk types, however, the updated Manual now requires the review of all risk types, including low-risk elements. While previously, the review cycle was expected to be every two years for high and medium-risk elements, with the expanded application, this cycle has been uniformly set to three years for high, medium, and low-risk elements.

Risk of excessive leverage and additional own funds requirements

The new Manual formulates new expectations in addition to changes and revisions. Among the more significant changes are the introduction of sections related to the risk of excessive leverage and additional capital guidance. Starting in 2023, in the assessment of significant risks falling within the scope of the components and supervision of the ICAAP, the evaluation of the need for additional capital related to the risk of excessive leverage has been incorporated in line with the EBA's expectations during ICAAP reviews. This means that the MNB assesses the institution's leverage risk based on a representative system of indicators and limits, primarily according to the criteria set out in the consultation paper had been published regarding the EBA SREP Guidelines[6]. As a result, the MNB may prescribe additional own funds requirements for supervised institutions if necessary, for which Article 104(1)(a) of Directive 2013/36/EU provides authorization.

In line with the EBA's expectations regarding the need for supervisory capital guidance related to excessive leverage risks is not limited solely to the evaluation of the need for additional capital. Starting in 2023, the Manual integrates the assessment of the need for supervisory capital guidance related to the risk as well. The purpose of this for the MNB to be able to prescribe the determination of the level and quality of capital as a guidance, similarly to the P2G[7] methodology, in excess of the overall leverage ratio requirement (OLRR). The difference from the P2G methodology is that at the latter the denominator of the ratio quantifying the stress effect includes the risk-weighted exposure, while at the first changes in the

6 Guidelines on common procedures and methodologies for the supervisory review and evaluation process (SREP) and supervisory stress testing under Directive 2013/36/EU

7 Pillar 2 Guidance

risk weights have no effect on the calculation of the exposure. In line with the EBA SREP Guidelines, the capital guidance related to the risk of excessive leverage shall be satisfied by T1 capital, as a minimum, but the MNB may also prescribe the provision of capital of higher quality than that – if necessary.

High risk portfolios

One of the changes related to the additional capital requirement regulations worth mentioning is the new section published in the annex on high-risk portfolios. The MNB determines annually the portfolios that pose supervisory concerns and therefore require institutions to maintain additional capital. The current annex has been supplemented with expectations for unsecured exposures with the parent company and its non-resident subsidiaries under controlling influence. The aim of the new expectations is to cover risks that are not currently covered by regulatory minimum requirements for restricting large exposures. These risks have emerged due to war situations and related sanctions, as Hungarian banks belonging to international banking groups may also face liquidity difficulties as a result of issues at other institutions within the banking group.

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In accordance with the international regulatory environment and domestic practice, the MNB is further expanding and clarifying the resources that concerns materially financial market participants and their legal requirements meet. KPMG has the expertise to interpret, implement and provide relevant professional advice on supervisory expectations and to develop appropriate practices.

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Previous amendments in the ICAAP-ILAAP-BMA methodology manuals have been summarized in these newsletters: January 2022, February 2021, February 2020

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