Financial Risk&Regulation

Changes in MNB ICAAP-ILAAP-BMA methodology manuals

Newsletter – February 2024

In December 2023, 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. For the fifth year now, KPMG experts have been analyzing and presenting the main changes following the annual update by MNB. The summaries of previous manuals are included in newsletters linked at the end of this summary.

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, as well as the amendment, addition and clarification of the paragraphs related to credit risks. In addition to the amendments, the chapters and references relating to the regulation of investment companies were deleted.

Interest rate risk in the banking book

The MNB amended the section of the Manual on the management of the interest rate risk of the banking book at several points. In our previous newsletter, we already summarized the latest elements of the EBA recommendation and previous amendments, and now we will review the latest changes in domestic regulations.

1. Calculation of the economic value of equity (EVE)

Clarifying previous expectations, the MNB emphasizes that banks must discount cash flows using the risk-free yield curve for all currencies in EVE-based calculations (including the Fair Value calculation). The risk-free yield curves used are expected to be constructed from the interest rates of the instruments with the lowest payment frequency (money market interest rates, FRA, futures and swap transactions) observed on the reference day of the calculation. If it is available for a specific currency, it is necessary to use the OIS yield curve. The standard interest rate shocks must be applied to the yield curve of the (spot) zero coupon, which consists of continuously compounded interest rates and is calculated from the risk-free yield curve used in the base interest rate scenario.

Another requirement is that (keeping in mind the principle of proportionality) banks should strive to estimate the total capital and interest cash flow until maturity in the case of transactions with variable interest rates during the EVE and Fair Value calculation. In doing so, the interest-fixing conventions typical of the transactions must also be taken into account (e.g., use of a multiplier, averaging of the reference interest rate, delay). Interest cash flows must be determined based on forward interest rates; the interest rates must be calculated as a nominal interest rate from the yield curves used in each interest scenario.

1 Internal Capital Adequacy Assessment Process
2 Internal Liquidity Adequacy Assessment Process
3 Business Model Analysis

A new element that banks can also take into account the potential risk-reducing effect of the correlation between the movements of the yield curves belonging to the forint, euro and US dollar currencies. The value of the end-of-period capital requirement calculated on the basis of dEVE and dINC (income) obtained as a whole for HUF, EUR and USD currencies, and the amount of the end-of-period capital requirement may be reduced to the extent corresponding to the effect of the correlation, but by no more than 15%. The correlation matrix used for this is visually presented in Figure 1, where the cells with a red background show the higher correlation between the individual interest rates.

Correlation	HUF 3M	HUF 5Y	HUF 20Y	EUR 3M	EUR 5Y	EUR 20Y	USD 3M	USD 5Y	USD 20Y
HUF 3M	1	0.59	0.34	0.06	0.04	0.06	0.12	0.1	0.06
HUF 5Y	0.59	1	0.77	-0.08	0.23	0.27	0.07	0.34	0.28
HUF 20Y	0.34	0.77	1	0	0.31	0.39	0.1	0.39	0.41
EUR 3M	0.06	-0.08	0	1	0.51	0.26	0.59	0.26	0.31
EUR 5Y	0.04	0.23	0.31	0.51	1	0.82	0.33	0.71	0.66
EUR 20Y	0.06	0.27	0.39	0.26	0.82	1	0.2	0.66	0.74
USD 3M	0.12	0.07	0.1	0.59	0.33	0.2	1	0.37	0.3
USD 5Y	0.1	0.34	0.39	0.26	0.71	0.66	0.37	1	0.83
USD 20Y	0.06	0.28	0.41	0.31	0.66	0.74	0.3	0.83	1

Figure 1: *Correlation matrix used to calculate the IRRBB diversification effect*

2. Stress tests related to the interest rate risk of the banking book

The MNB had previously required that banks calculate the impact of standard interest rate shocks on major currencies with regard to the banking book, and these effects had to be taken into account when determining the capital requirement.

Previously, this definition only applied to those currencies in which the sum of the bank's assets, liabilities and off-balance sheet transactions denominated in the given currency and not registered in the trading book exceeds 5% of the holdings of all banking book items; and, if the amount of currencies with a ratio of more than 5% does not make up 90% of the entire bank book, then also for those with a ratio of less than 5%.

However, in addition to the above, the range of currencies taken into account also includes currencies that meet one of the following conditions: currencies that are considered official currency or legal tender in a country where the institution's prudential group members have their headquarters must also be taken into account; and also those for which, according to the bank's preliminary estimates, the risk exposure measured by sensitivity indicators of income and/or economic capital value exceeds 5% of the sensitivity indicators calculated for the entire banking book.

Preferential capital requirements

As usual, the MNB focused the review and amendments of the conditions for the preferential capital requirements on the reductions for green loans for residential purposes, the rules relating to companies and local governments were only affected by minor clarifications. During the previous year's update, more sophisticated conditions came into effect, according to which more categories appeared. The 2023 update retained the previously separated new and used residential buildings from the point of view of purchase, and the sale and renovation of used residential buildings continue to form a separate category. In addition, this year's demolition also includes residential buildings that were renovated prior to purchase, which appeared as a new category last year, but the requirements for energy classification have become more stringent.

For loan contracts signed after 1 November 2023, for classification of up to 68 kWh/m2/year for the combined energy efficiency attribute and energy efficiency rating "A+", the rate of the Discount shall be 5%. Another tightening is that the 7% discount for building permit applications submitted after 1 November 2023 can only be applied in the case of „A++" or higher classification, while under last year's conditions, it was automatic from „AA" quality.

It shall be 5% in the case of modernization measures, except when the loan contract is dated before 31 October 2023 and following the implementation of the modernization measure the energy efficiency rating of the residential building is "AA" or better; then it shall be 7%.

It shall be 5% for renovation and the purchase of second-hand residential buildings, except if the energy efficiency rating of the second-hand residential building purchased after the renovation is "AA" for building permit applications submitted by 31 October 2023 or "A++" or better for building permit applications submitted after 1 November 2023, then it shall be 7%.

The changes are summarized in the table below.

<table>
<tr><th colspan="6">2023</th></tr>
<tr><td>Energy efficiency category</td><td colspan="3">BB</td><td colspan="2">AA</td></tr>
<tr><td></td><td colspan="2">Before 09.06.2022
90 kWh/m²/yr</td><td>After 09.06.2022
80 kWh/m²/yr</td><td colspan="2"></td></tr>
<tr><td>Construction or purchase of new residential buildings</td><td colspan="3">5%</td><td colspan="2">7%</td></tr>
<tr><td>Purchase of used residential buildings</td><td colspan="3">5%</td><td colspan="2">7%</td></tr>
<tr><td>Purchase of used residential building after renovation</td><td colspan="3">5%</td><td colspan="2">7%</td></tr>
<tr><td>Renovation or modernization</td><td colspan="3">5%</td><td colspan="2">7%</td></tr>
<tr><th colspan="6">2024</th></tr>
<tr><td>Energy efficiency category</td><td colspan="2">BB</td><td>A+</td><td>AA</td><td>A++</td></tr>
<tr><td>Change in conditions</td><td>Before 09.06.2022
90 kWh/m²/yr</td><td>Between 09.06.2022 and 31.10.2023
80 kWh/m²/yr</td><td>After 01.11.2023.
68 kWh/m²/yr</td><td>Before 31.10.2023</td><td>After 01.11.2023.</td></tr>
<tr><td>Construction or purchase of new residential buildings</td><td colspan="3">5%</td><td colspan="2">7%</td></tr>
<tr><td>Purchase of used residential buildings</td><td colspan="3">5%</td><td colspan="2">7%</td></tr>
<tr><td>Purchase of used residential building after renovation</td><td colspan="3">5%</td><td colspan="2">7%</td></tr>
<tr><td>Renovation or modernization</td><td colspan="3">5%</td><td colspan="2">7%</td></tr>
</table>

source: compiled by the author

In addition to the preferential capital requirements for green loans, a new point was added to the Manual with the conditions for validating the capital requirement reduction effect of the (counter-)guarantees with a cap. Since the capital-reducing effect of (counter-)guarantees provided with a cap typically cannot be taken into account in Pillar 1 because the requirements of Article 213 and Article 215 (1) of the CRR[4] are not met, the MNB will apply the lower capital requirement linked to the quality of the (counter-)guarantor in the annual ICAAP reviews, using the SREP factor. The background to this is that the extent to which the cap applies to the financed transaction is not known to the lender (the extent of the credit protection is therefore not clearly defined and incontrovertible), and also the management and actual utilization of this cap is outside the direct control of the financier. In the event of a possible call for redemption, especially in a crisis situation, it is not ensured that the (counter-)guarantee will always have a margin available within the cap and that the guarantee to the lender can thus be honored.

4 Regulation (EU) No 575/2013 of the European Parliament and of the Council

Operational risk

According to the MNB's expectations, the application of the new operational risk standard method developed as part of the finalization of Basel III may be effective by January 1, 2025. According to the submitted amendment proposal, the new method (SMA) replaces all of the previously used methods, as they are not sufficiently risk-sensitive in the opinion of the Basel Banking Supervisory Committee, and the differences between the internal modeling methodologies make it difficult to compare the measurements.

Accordingly, the MNB still recommends performing calculations according to the new methodology in addition to the currently used methods. This helps to detect any significant deviation of the capital requirement calculated with the SMA compared to the current model, since the fact of unhedged operational risk is relevant from a supervisory point of view, and if the MNB finds so, it will impose an additional capital requirement during the SREP under pillar 2 to cover risks in full.

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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.

5 Standardised Measurement Approach
6 No english version

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Previous amendments in the ICAAP-ILAAP-BMA methodology manuals have been summarized in these newsletters:

March 2023, January 2022, February 2021, February 2020[6]

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