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Financial Risk&Regulation

Changes in MNB ICAAP-ILAAP-BMA methodology manuals

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In December 2024, Central Bank of Hungary (MNB) according to its 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[4] for supervised institutions. In addition to the revision of content, the MNB also changed the usual structure in previous years, so some chapters were placed elsewhere. The renewal of the structure was probably necessary due to a more logical structure. Among the more significant content changes, the IRB shortfall related to credit risks, the methodology for determining the capital requirement of the IRRBB, and the part concerning the calculation of the capital requirement for operational risk deserve mention. As usual, the annual review and refinement of the measures for preferential capital requirements for green loans was carried out, and the minimum requirements for the institutions' internal stress test were supplemented with the expectations of the climate risk stress test.

Following the annual update of the MNB, KPMG experts analyze and present the main changes for the sixth year now, and in connection with this and similar topics, we recommend our April 2024, February 2024, March 2023, November 2022, January 2022, and February 2021 newsletters.

Credit risks

For clarification, the MNB highlighted that the concentration risk HHI[5] index must be determined at the client group level, and that, with the application of CRR3[6], the definition set out in Article 5, point 9 of the CRR becomes the guiding principle for the eligibility of SMEs. Accordingly, a "small and medium-sized enterprise" or "SME" is an enterprise or company whose annual turnover does not exceed EUR 50,000,000 according to its most recent consolidated financial statements.

With regard to the IRB[7] shortfall, the MNB highlighted the recent experience and emphasized that the RWA limits the amount of surplus that can be taken into account to 0.6%, and sets the amounts in excess of this as the additional Pillar 2 capital requirement. The MNB justified this approach with the following aspects:

- In several cases, the impairment overlays during COVID did not prove to be temporary, and in some cases they also cover risks outside of credit risk models of the banks.

1 Internal Capital Adequacy Assessment Process
2 Internal Liquidity Adequacy Assessment Process
3 Business Model Analysis
4 Not yet published in english
5 Herfindahl–Hirschman index
6 Capital Requirements Regulation 3 - Regulation (EU) 2024/1623 of the European Parliament and of the Council of 31 May 2024 amending Regulation (EU) No 575/2013 as regards requirements for credit risk, credit valuation adjustment risk, operational risk, market risk and the output floor
7 Internal Ratings-Based approach to credit risk
8 Risk Weighted Assets

- There were experiences where the impairment was multiple times the credit risk VaR[9] estimate, even though the VaR estimation was meant to cover the losses expected every 1000 years, i.e. the two risk measures were inconsistent.
- Several banks failed to adjust the IRB provision excess value with the compensating effect of excess impairment already taken into account in CET1[10].
- At the same time, as a positive example, several banks have already applied the RWA limit.

Market risks

With regard to trading book market risks, the MNB expects the banks to take at least 50% of the difference between the FRTB[11] and the current capital requirement, if positive, when determining the ICAAP capital.

With regard to bank book interest rate risks (IRRBB), the MNB expects that at least O-SII[12] institutions must quantify the basis risk of their bank book portfolio, taking into account the imperfect correlation between the various interest rates and yields, primarily the BUBOR and yield changes of government bonds. The MNB does not impose strict methodological and ICAAP capital requirements but expects risk monitoring in order to increase awareness. There are no specific regulations for the capital requirement either, but the MNB uses the EVE sensitivity indicator in its own calculations, which uses forward interest rates and a correlation matrix determined on the basis of historical data. At the same time, institutions may also need more complex simulations.

The MNB emphasized that it expects the application of the interest floor for liabilities if it is a legal obligation.

Emphasizing the importance of bank book credit spread risk (CSRBB), the MNB describes its expectations in a separate subsection in the new handbook. In addition to strengthening the most important EBA rules, the MNB emphasized that the impact of CSRBB for O-SII institutions must be measured at least in EVE and NII indicators, but it is also recommended to use CS01 (the impact of a 1 basis point change in credit spread), historical simulations and other risk measures. It is also necessary to establish governance processes in order to measure, manage and monitor risks.

In Appendix 2, the MNB modifies the rate of interest shocks used in the benchmark model, based on the July 2024 BCBS 578 standard. We analyzed the consultative version of the BCBS standard in our April 2024 newsletter, together with the supervisory focal points of the EBA. The shocks are presented in Table 1. As a temporary relief, the MNB does not take the increase into account in 2025 in the TSCR[13], but in the P2G, and on the other hand, it is possible to calculate the effects of the new shocks through the use of calculations according to the old system and multipliers according to Table 2.

Currency	Parallel	Short	Long
HUF	4,00%	5,00%	3,00%
EUR	2,25%	3,50%	2,00%
USD	2,00%	3,00%	2,25%

Table 1: *The interest rate shock parameters expected by the MNB for the most important currencies*

Currency	Multiplicator
HUF	1,333
EUR	1,125
GBP	1,100
CHF	1,750

Table 2: *Multipliers to be used in the simplified calculation of new interest rate shocks*

Liquidity risks

The MNB emphasized that it expects banks to have the ability to calculate the LCR[14] indicator on a daily basis, which they must perform at certain intervals on a test basis. Efforts should be made to include as few estimates as possible. In addition, the MNB expects that if the indicator is close to the legal or MNB limits, then the banks calculate LCR and the relevant forecasts with a higher frequency.

The MNB also expects the supervisory liquidity stress test (FLST) to be run regularly, at least quarterly, and its internal and external reporting. Annex 12, which supports the supervision of unstable sources, was also fine-tuned this year.

8 Risk Weighted Assets
9 Value at risk
10 Common Equity Tier 1
11 Fundamental Review of the Trading Book
12 Other Systematically Important Institutions
13 Total SREP Capital Ratio
14 Liquidity Coverage Ratio

Preferential capital requirements

In previous years, the MNB usually focused the review and amendments of the conditions for the preferential capital requirements on the green capital requirement discount for residential purposes, while the rules related to companies and municipalities were affected by minor clarifications. Since the change in energy classifications was already implemented in the previous version, only clarifications were made in this case, and the discount applied to the value of the additional capital requirement of the SREP is no longer be applied per segment (e.g. mortgage, personal loan, etc.), but to the portfolio of the entire residential segment. Furthermore, the amount of the total capital requirement determined under the SREP, which takes into account the discounts, cannot fall below the level of the 1st pillar capital requirement. The discount is still deducted from the credit risk part and can amount to 1.5% of the TREA[15].

In connection with the green corporate and municipal capital requirement discount, the Supervisory Authority implemented changes similar to those for the residential sector. While previously the limit of 5% and 7% discounts was applicable at the level of the 2nd pillar capital requirement, the new requirements are also adjusted to the amount of the total capital requirement defined under the SREP, in line with the residential segment, minimized at the level of the 1st pillar value and projected on the entire corporate segment.

The amount of the preferential capital requirements of the DLT project has changed, the applicable amount of which is unified 2% of the capital requirement according to the SREP.

Operational risks

Application of the new operational risk standard method developed in the framework of the finalization of Basel III is expected from January 1, 2025. According to the submitted amendment proposal, the new method (SMA[16]) replaces all of the previously used methods, the facts and justification of which were already dealt with in the previous Manual. The operational risk capital requirement as per SMA is detailed in CRR3.

The new standard method combines an indicator based on the size of the institution's business activity (Business Indicator Component, BIC) according to Basel III with an indicator that takes into account the institution's past loss data. However, the component of the operational risk capital requirement calculated according to the SMA methodology (Internal Loss Multiplier, ILM) based on loss events is not applicable according to the CRR3 regulations, in other words, in compliance with EU rules, the 1st pillar value of the capital requirement is the same as the value of the BIC.

However, in its methodology manual, the MNB requires the quantification of the annual operational risk loss for all institutions subject to a complex SREP investigation, which is to be calculated as the sum of the net loss of individual operational risk events[17].

During the calculation of the annual operational risk loss, it is necessary to take into account at least those operational risk events in which the net loss reaches or exceeds EUR 20,000. If the value of the ILM exceeds 1, the MNB may impose an additional capital requirement in order to fully cover the risks.

In relation to operational risks, it is worth mentioning that the MNB harmonized the definition of critical and important functions in the Manual in relation to ICT[18] risks in accordance with the DORA[19] regulation.

Climate risk stress tests

AThe MNB has defined minimum supervisory requirements for the internal climate risk stress testing of institutions, according to which, from January 1, 2025, based on the provisions of the Green Recommendation[20], credit institutions fall under the complex SREP are expected to conduct scenario analysis or stress testing of climate change-related and environmental risks - together with risks considered material - also be evaluated through. Furthermore, it is expected that they also examine how climate change-related and environmental risks can affect the credit institution's capital adequacy and business model, primarily transition risks and secondarily physical risks. Institutions are expected to analyze climate

15 Total Risk Exposure Amount
16 Standardised Measurement Approach
17 Net loss = gross loss – reimbursement received from a third party (e.g. insurance)
18 Information and communication technology
19 Regulation (EU) 2022/2554 of the European Parliament and of the Council of 14 December 2022 on digital operational resilience for the financial sector and amending Regulations (EC) No 1060/2009, (EU) No 648/2012, (EU) No 600/2014, (EU) No 909/2014 and (EU) 2016/1011
20 Recommendation No 10/2022. (VIII.2.) of the Magyar Nemzeti Bank on climate-related and environmental risks and the integration of environmental sustainability considerations into the activities of credit institutions

risks along several scenarios, covering both short- and medium-term risks, but at least a 2-year time horizon.

According to the Manual, it is recommended, but not expected, to examine the sustainability of the business model using longer-term scenario analysis or stress testing for various climate change-related and environmental risk scenarios. On the other hand, as part of its capital planning, credit institutions are expected to evaluate their capital adequacy according to a reliable baseline and several unfavorable scenarios.

The credit institutions' stress testing policies are expected to be reviewed in light of climate change-related and environmental risks. For all institutions, the MNB expects the documentation of the climate risk stress test to be prepared, which fully includes the methodology of the climate risk stress test (as part of the general stress test documentation, where appropriate).

Supervisory P2G stress tests

The MNB emphasized that when calculating P2G[21] stress tests, the calculations related to bonds and derivatives are made from analytical data, meaning that it is important to ensure good data quality from the institution's side. The MNB also clarified the calculation of the effects of the extra-profit tax and the transaction fee. The MNB also monitors the expected development of the LCR, but at the same time mentions that it uses simplifying assumptions here.

The examination of compliance with MREL[22] requirements was added as a new element. If it is necessary to issue a new MREL during the simulation, it is done with a unified methodology and parameters, which is based on historical observations. The effect of the issued MREL papers on interest income is also reflected in the PnL.

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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.

21 Pillar 2 Guidance
22 Minimum Requirements of own funds and Eligible Liablilities

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