Recommendation No. 7 of 2006 (IX.28) of the Board of the Hungarian Financial Supervisory Authority

On increasing the effectiveness of credit risk management

I. The goal and scope of the Recommendation

1. **The goals of the Supervision's operation include** facilitating and continuously supervising the prudent and effective operation of organisations and persons engaged in providing financial services, supplementary financial services, investment services, supplementary investment services, clearing house, investment management, commodity exchange service provision, insurance, insurance mediation and insurance consultancy activities, as well as voluntary mutual insurance funds, private pension funds, public warehouses, venture capital enterprises, venture capital funds, venture capital fund managers, exchanges and their members (hereinafter collectively: financial organisations), along with the exercising of the rights of their owners with due care, in order to promote the undisturbed and effective operation of the money and capital market, the protection of the interests of customers of financial organisations, the transparency of the conditions and circumstances prevailing in the market, to strengthen confidence in financial markets, and to maintain fair competition in the market. in the framework of these endeavours the Supervisory Council of the Hungarian Financial Supervisory Authority (hereinafter: Supervision) formulates and publishes Recommendations. The general goals of the Recommendations include strengthening the predictability of law enforcement and facilitating harmonised and standardise application of the relevant pieces of legislation.

2. **The goal of this Recommendation** is to facilitate harmonised and standardised application of legal regulations governing the management of credit risks.

3. **Expectations relating to the application of the recommendation**:

- To improve the efficiency of credit risk management
- To facilitate compliance with statutory rules.

4. **The Recommendation is addressed to** (its subjective scope includes) all financial organisations assuming credit risks. Financial organisations may apply the Recommendation in view of its activities and the special features of the risks relating to those activities, in line with the quality, scale and complexity of its operations.

5. **Legislation underlying this Recommendation**:
The management of credit risks of credit institutions is governed by the provisions of Act CXii of 1996 on credit institutions and financial enterprises (Banking Act) on prudent operation as well as Decree 14/2001. (iii. 9.) PM issued by the Minister of Finance on the criteria of the rating and valuation of receivables, investments, off-balance sheet items and collaterals. This Recommendation is aimed at drawing attention to deficiencies associated with four areas of credit risk management (strategy, regulation, limit system, monitoring), which have often been observed to entail various problems, without aiming to cover all expectations relating to its subject matter, which have already been dealt with in a comprehensive manner in Recommendation No. 8/2001 issued by the President of the Supervision on credit risk management. No references are made in this Recommendation to provisions contained in various pieces of legislation in outlining the principles and expectations, i.e. where additional requirements are prescribed by law, the Supervision continues to expect compliance with those requirements.

II. Preamble

6. In the course of its audits carried out during recent years the Supervision has observed a trend of improvement in the standards of regulation and in the quality of the risk management activities of the supervised institutions. At the same time, thematic audits and assessments carried out in the wake of the most recent trends in the financial sector (an intensive growth in the activities of financial enterprises accompanying the intensification of competition in the money market, weakening of a number of large corporate debtor groups, dynamic growth on the basis of retail loans and new innovative products), and comprehensive audits have also indicated that a number of institutions are in need of reconsidering the prudential conditions of risk assumption and of further strengthening of the monitoring process.

III. Improving the efficiency of credit risk management

III./1. Strategy

The Supervision recommends that the supervised institutions should specify their customer segment representing strategic value and targets from the aspect of risks as well and that they should regard the careful and proper positioning of the risks entailed by products as a kind of an initial phase of the risk management activity. Thus, in particular:

7. The need for improving the definition and monitoring of products, activities and customers, credit appraisal and the assessment of creditworthiness should appear together with the specification of the risk strategy of the institution, along with making available the required set of instruments.

- The term *set of instruments* should include a strict and consistent regulatory background and the availability of human resources and iT capacity of adequate standards.
- Consistent and uncompromising compliance with the internal regulations and its controlling are indispensable for the operation of the relevant instruments, along with calling those responsible to account for their activities in this aspect.

8. After establishing the risk position of the institution and the group members the strategy has to be developed for the whole of the group as well. Monitoring of risks assumed by another member of the Group is a task that should be coordinated by the parent institution, which includes limiting and keeping records of the risks assumed by the group of institutions with respect to the given group of customers, along with coordinating the applied risk management techniques.

9. The parent institution is in charge of aligning the strategy of the subsidiary institution to that of the group as a whole, while highlighting the special features as well, along with updating these at least once a year, from the aspect of the planning of the income structure of the institution/group and of the management of its risk.

10. Lowering the standards of conditions for lending (income certificate, requesting certificates issued by the tax authority (APEH), coverage requirements, e.g. LTV ratio, securing credit risk by collateral security items) in order to attain a competitive advantage in the market is not considered to be a desirable approach, because it may result in a significant increase in the institution’s risks.

11. Financial institutions should make efforts to avoid financial schemes where the sources of loan repayment cannot be controlled or where at the time of extending a loan it is not possible to soundly assume that the borrower will be capable of repaying the loan from his available income. Not requesting an income certificate may contribute to legalising income on which no taxes are paid (originating from the black economy).

- The ‘know your customer’ approach should be applied in the debtor rating process.
- The regular source of income for loan repayment as well as for the costs of living should be documented.
- Documented assessment of the borrowers’ liquidity and rating the receivables on a regular basis should be insisted on even in the case of low risk transactions (guaranteed transactions, indirect state guarantee etc.).

12. The Supervision does not consider a lending strategy based solely on collaterals as a recommended practice: the source of loan repayment should primarily consist of income and cash-flows generated by the borrower. The aim is not to recover from the collaterals.

13. The prevailing standards of the financial culture of the market and customers should be taken into account in formulating the credit facility. Efforts should be made to ensure that customers familiarise themselves with and understand the detailed conditions of the product and the actual risks they will be facing.

14. The need to expand the market must not result in disregarding the restricting elements of the relevant regulations and rules.

III./2. Regulation

15. Within the regulatory environment the risk management process should include the development of a strict decision making mechanism and hierarchy. In establishing the applicable decision level in addition to the amount of the exposure the type and risk rating of the customers and transactions should also be taken into account.

16. Risk management, and within this, the nature of the monitoring activity, varies by customer segment (small and large enterprises, municipalities, retail customers, financial enterprises, investment service providers etc.), therefore a variety of special features should be developed in the internal regulations of institutions operating in a broad range of segments. in view of the weights and sizes of the segments and the relative proportions there may be a case for differentiation in the course of risk management and the organisation of monitoring activities.

17. The rules referred to in the preamble of this Recommendation do not equally apply to all participants of the market, but the Supervision considers it important that the internal regulations and the applied practices of all institutions running credit risks should include elements of debtor rating, collateral valuation and receivable rating.

18. The debtor rating procedure should aim to clearly identify the individual creditworthiness of the given business unit (for which a loan is to be extended), along with the proportions of potential loan extension. in addition to the institution’s risk assumption intent the limits should be linked primarily to objective factors, including the assessment and evaluation of the economic and financial positions of the entities for which limits are to be set, their creditworthiness, liquidity, size and economic potential.

- Different calculation methods, ratios, scoring etc. should be elaborated and integrated in the internal regulations in the course of the debtor rating procedure to enable processing economic information (annual reports, data supplies) of different data contents, of the various customer segments.
- Information available concerning the owner of the borrower should be taken into account only to a limited extent (as specified by law) in establishing the debtor rating category (particularly in the case of a bad borrower with a good owner), and no significant change in the rating of the individual borrower is considered to be acceptable.
-

- In the case of a lower debtor rating a higher rate of collateral coverage should be required in assuming a credit risk.
- If the debtor rating system of the foreign parent company of the given financial institution is not or not fully in line with the Hungarian legal regulations, it should be applied by the lending institution with adequate supplementation.

19. From the aspect of risk management, controls operated in line with the 'four-eye' principle is a dominant element of the debtor rating and receivable rating process.

20. in the case of risk management and monitoring of a subsidiary of the financial institution methods other than those applied to borrowers owned by others (independent borrowers) should be applied, namely:

- The parent institution is represented through its officers in the governing bodies of risk assuming subsidiaries or participations, who are expected to participate in formulating the conditions and circumstances of the operation of the institution and in calling those responsible for controlling to account for their activities.
- In the case of the risks assumed by subsidiaries and participations decision making should be controlled by the parent company above a certain limit amount.
- In organising the governance of subsidiaries the application of a so-called 'matrix type' solution should be considered.

21. Applying preferential treatment with reference to ownership relationship should be refrained from in assessing the (customer) risk of a subsidiary. (No exceptional procedure should be applied even if the owners of the institution include a bank, in assessing the customer risk.)

III./3. Limit system

An adequately shaped limit system facilitates effective management of the risks generated by the operation of the institution. To this end, the following should be taken into account:

22. In its internal regulations the institution should clarify the definition of 'limit' as an instrument to be established for limiting the risk to be assumed and borne, and it should identify the threshold for its application.

23. Within the various limits (product, country, sector, partner and customer limits) the partner and the customer - or debtor - limit should be closely linked to the mandatory debtor rating.

24. Customer limit should be a concrete figure, elaborated in advance for each relevant customer segment and sector, specified in the debtor rating code of the institution, based on calculations carried out in the course methodical creditworthiness assessment, on ratios and/or a formula applying an expert rules (rules defined by experts), providing orientation, expressing the largest amount of exposure that may be reasonably assumed with respect to the customer concerned.

25. The customer limit should be broken into time brackets within which the uncertainty of the value projected for a later point in time assumes a degressive willingness to take risk.

26. As a general rule, better customer rating permits a higher limit but this principle is significantly affected by the size of the customer and the - type of the - available collateral.

27. In filling out the customer limit with real risks and commitments the institution should, as far as possible, take into account any other financing already provided for the borrower by other lenders.

28. It is important that the subsidiaries of a financial institution - if they apply the limits established (and allocated to them) by the parent institution - should be familiar with the structure of the limit system, in relation to the debtor rating system.

29. If a limit system is other than the one applied by the parent institution but the institution is aware of the latter, the institution should consider applying those limits and request their allocation to coordinate the risks assumed and the risk assumption practices of the group.

III./4. Credit monitoring activity

30. Monitoring should already be started by checking if the decision terms were included in the credit contract.

31. The conditions for disbursement should be reviewed as part of the monitoring activities, along with checking compliance in general with the relevant external and internal rules and the approved principles.

32. Limit monitoring and customer risk measuring as minimum requirements to be met by monitoring, should be supplemented by close cooperation with the mandatory quarterly receivable rating and with the tasks relating to collateral security items.

32.1. The balance sheet items under various headings in relation to the various debtors (investments, credits), and off-balance sheet items (pending and future exposures) should be combined in establishing the rates of utilisation of the limits set up for a customer group.

32.2. In the mandatory quarterly rating of receivables the institution should carry out detailed individual transaction rating above a value limit set in advance in its internal regulation. Beyond such value limit it is not enough to simply check the fulfilment of the debt servicing obligations (repayment discipline) and the transaction’s collateral background and perhaps the transactions on the customer’s account, indeed, special attention should be paid to any change in the financial position, stability and income generating capacity of the customer/customer group, as described below:

- The monitoring of changes in the creditworthiness and liquidity of the customer should be combined with the rating of receivables. In the course of monitoring risks assumed the fulfilment and performance of the contractual obligations - along with trends in the financial and economic position of the customer - should be documented.
- The monitoring system - detailed as described above - should be based on objective economic information made available at regular intervals (recommended: requesting individual financial data quarterly, along with consolidated information in the case of groups, once every half year). The customer’s obligation to supply such information should be laid out in the contract concerning risk assumption.
- The lender should provide for the processing and analysis of the financial data requested from the borrower, and for drawing conclusions concerning the future behaviour of the customer.
- The lender should consider default and breach of contract by the debtor if the above data set as a pre-requisite for risk assumption is not supplied, in which case the lender should take the appropriate actions.

33. Controls integrated in the processes may also be applied to facilitate the effectiveness of monitoring.

34. In the case of financing financial enterprises efforts should be made to get acquainted with the risk management system of the borrower and in addition to the processing numerical economic information the operating risks of the borrower financial institution should also be taken into account.

35. In the course of monitoring the collateral security items, in addition to the physical existence of the collaterals the institution assuming credit risks should also keep tracks of any changes in the value of the collaterals and assess them in the course of rating the receivables.

36. Failing to conduct monitoring in relation to certain collateral security items (e.g. state guarantee) or with regard to the owner - with reference to low risk - is not considered to be 'good practice'.

37. In the case of project credit regular and adequate technical control and monitoring of performance should be provided for, regardless of the location of the implementation of the project. in general, any change in the mode of financing should not result in disregarding any specific individual risk (performance, profitability, coverage risk etc.).

38. If a project is financed through a project firm, to avoid that other activities of the borrower distort the picture that can be formed of the actual situation. if this is not possible, provisions should be included in the financing contract concerning separated recording of the economic data relating to the project, to ensure effective monitoring.

39. In the course of monitoring the institution should pay attention to ensuring continuous maintenance of the transparency of the customer/group.

40. in the course of the management of a borrower or transaction financed by more than one credit institutions (syndicated loan), none of the financing institutions may go without receivable (and debtor) rating. Co-financing cannot in itself be considered to be a risk mitigant, since each of the lenders is bearing its own share of the credit risk.

41. The unit primarily in charge of rating receivables should be the risk management unit, the renumeration of which must not depend directly on the results of rating or on the extent to which the portfolio is assigned to categories, or on the expectations of the owner concerning the quality of the portfolio.

42. in the case of a deal that is clearly becoming a 'non-performing' one, modifying - easing - the original credit conditions is not considered to be 'good practice'. in this case collection from suitable collateral security items should be initiated, and a radical transformation of the structure of the deal should be aimed at (e.g. besides credit-leasing conversion, rescheduling repayment, involvement of additional collateral security items if possible or improving the collateral position, for example turning into owner from mortgage through a credit-leasing arrangement). Particularly, the lender should not assume increased risks as the loan/collateral value ratio deteriorates, than it was running before the loan turned into a 'non-performing' one.

IV. Closing provisions

43. Recommendation is a legal instrument issued pursuant to Article 9/C (1) c) of Act CXXiV of 1999 on the Hungarian Financial Supervisory Authority.

44. The contents of the Recommendation issued by the Supervisory Council express and reflect requirements laid out in legislation, principles and methods proposed to be applied on the basis of the Supervision's practices in the application and enforcement of the law, along with market norms and standards. The Supervisory Council emphasises that financial organisations may integrate the contents of this Recommendation in their regulations. In this case, the financial organisation concerned is entitled to point out that the contents of its relevant regulations are in concert with the relevant recommendation issued by the Supervisory Council.