Information on high-risk portfolios as key priorities in the supervisory review process (SRP) and on the related additional capital requirement

Annex 1 forms part of the guidelines for the Supervisory Review Process (SRP) and it provides an overview of the risk assumptions and high-risk portfolios for which the Hungarian Financial Supervisory Authority (HFSA) prescribes additional capital requirement when the internal capital requirement of the institutions is calculated, and in connection of which it will carry out more stringent inspections in the course of the SRP. The HFSA will review the high-risk portfolios detailed below on an annual basis.

Based on the relevant sections[1] of the CRDIV, which will take effect in the near future, if the HFSA identifies risks at institutions with similar risk profile and business model, risks which may represent a significant risk for the financial system, the HFSA may manage these institutional risks in an uniform manner.

According to the above – contrary to the earlier practice – from 1 March 2013 the HFSA will set, as a rule of thumb, additional capital requirement for the total portfolio with regard to risks and activities specified in the high-risk portfolios. The requirements set for high-risk portfolios in earlier Guidelines are no longer in force from 1 March 2013.

The HFSA includes among the high-risk portfolios those risks that on the basis of analysis and supervisory information give rise to supervisory concern in the Hungarian market. In order to manage such risks it is justifiable and expected that the institutions concerned hold additional capital. This requirement is designed to achieve several supervisory objectives:

- The HFSA wishes to emphasize that with regard to certain risks, the risk of the given activity is found to be so significant that the HFSA deems it justified to generate additional capital for coverage, specified between 0 and 100%, depending on the level of the risk management methods applied. For institutions which apply high-level risk management methods and satisfy the relevant HFSA recommendations, the capital adds-on imposed is 0%, whereas for those which apply low-level risk management methods it is 100% .
- In the case of certain risks (commodity, activity, practice), the HFSA's objective is to protect the market from the uncontrolled spread of such risks. In this case, the level of the risk is found to be so significant by the HFSA that it carries serious threats for the given institution, for the customers of the institution and for the market as a whole. The HFSA prescribes an additional capital requirement of 50 to 100% for these risks in line with the level of the risk management method applied in order to provide sufficient capital coverage for such risks.

By applying the principles of competition neutrality and equal treatment, the HFSA continues to regard the expectations as part of the general good[2], therefore it applies the expectations in a standard manner for all market players concerned. This also means that the HFSA expects

[1] Application of supervisory measures to institutions with similar risk profiles

[2] According to the EU Commission's explanation No. 97/209/6, the following constitutes protection of the general good: "protection of the recipient of services, protection of workers, including social protection, consumer protection, preservation of the good reputation of the national financial sector, prevention of fraud, social order, protection of intellectual property, cultural policy, preservation of the national historical and artistic heritage, cohesion of the tax system, road safety, protection of creditors and protection of the proper administration of justice."

money and capital market players not subject to consolidated supervision in Hungary (including branch offices operating in Hungary) to exhibit a market behaviour that complies with the conditions described below, and the HFSA will enforce compliance with such conditions by other supervisory tools and under international cooperation schemes.

Risks treated as high priority ones by the HFSA and which may arise at institutions subject to the CRD

1. Coverage of losses expected from credits more than 90 days overdue

The proportion of the non-performing loans of credit institutions has reached a high level by the first half of 2012; on total sector level the NPL ratio for the corporate portfolio was 18.9%, whereas it was 17.7% for the retail portfolio. Based on the current analyses, this ratio is not expected to decrease significantly in the future, and therefore the HFSA regards it particularly important for the institutions to provide coverage for the losses expected from non-performing loans by prudently evaluating the coverage and by recognising the necessary impairments.

When formulating its expectations for high-risk portfolios, the HFSA lays the emphasis on recognising sufficient impairments because of the following factors:

- the institutions’ collateral evaluation practices are different;
- the low-liquidity of markets represents today a limit to debt recovery from the collaterals: in the present economic situation the individual collaterals securing the credit deals are difficult to or cannot be sold at all due to the stagnation of the real property and used automobile markets.

Based on recovery experiences, the HFSA establishes an average loss rate of 40% for secured loan portfolios (retail and corporate/project loan portfolios collectively), and requires credit institutions to recognise at least a 40 % impairment to cover the losses expected from non-performing portfolios. The experience of recovery shows a higher loss rate, approximately 80%, for unsecured loans, so a minimum average 80 % impairment is expected for unsecured loans. The HFSA may derogate from expecting the impairment amounts set out above if the credit institution sufficiently substantiates during the SRP procedure that its model used or its practice followed is adequate for the calculation of the impairment.

Based on the recovery data observed in the course of the SRP, the LGD[3] ratios are as follows:

- in retail loans secured by real property the recovery from collaterals is not typical at present (and in the recent four years). A more than 90 days overdue mortgage loan cures and recovers from a non-performing status with a probability of 15 to 50%. The LGD applied for real estate secured loans varies between 35 and 40%;
- the source of recovery on unsecured retail loans is usually the payment of the customer or the sale of claims, consequently, the LGDs of these loans are considerably higher: approximately 80 to 90%;
- in the case of corporate loans significant number of more than 90 days orverdue loans become performing again, therefore LGDs of 45-50% for corporate loans are good approach for the losses.

[3] LGD = loss given default

The magnitude of the prescribed additional capital: as regards exposures in portfolios more than 90 days overdue (excluding retail motor vehicle financing), the magnitude of the prescribed additional capital is the difference between the minimum average portfolio-level impairment expected by the HFSA and the level of average impairment recognised by the institution for such portfolio.

2. Retail motor vehicle financing

The HFSA believes that in the case of retail motor vehicle financing, the enforceability and sale of the existing collaterals may give rise to further problems in addition to the increase in portfolios which are more than 90 days overdue. Therefore, the HFSA also requires in this case that appropriate impairment should be accounted for. When evaluating motor vehicles serving as collateral, the HFSA takes into account the EUROTAX sales prices, whereas for motor vehicles whose age exceeds 12 years during the period of financing the value of the collateral is considered to be 0.

The magnitude of the prescribed additional capital: the difference between the value of the exposures, calculated in Hungarian forint, in the more than 90 days overdue portfolio with the recognised collaterals and the recognised impairment, or – provided that the institution is able to demonstrate – the difference between the value of the exposures, calculated in Hungarian forint, in the more than 90 days overdue portfolio with the amount of the expected recovery and the recognised impairment.

3. Balloon/bullet transactions

Based on the experience of the recent past, the HFSA continues to regard such transactions with more than 1 year maturity as risky where interests and fees are repaid during the term while principal repayment (either the entire amount or a decisive, at least 60% portion of it) falls due upon the expiry of the loan.

The magnitude of the prescribed additional capital: for the part of this portfolio that is more than 90 days overdue additional capital calculation will be done as set out under point 1. As regards performing loans or those that are less than 90 days overdue, the additional capital requirement may be 0-100% of the Pillar 1 capital requirement of the portfolio concerned.

4. Yen-based loans

The HFSA applies additional capital requirement for yen-based loans from 8 May 2008 within the framework of the SRP. The HFSA continues to regard yen-based financing as risky, and it therefore enforces additional capital requirement for the total yen-denominated foreign currency loan portfolio.

The magnitude of the prescribed additional capital: 50-100% of the Pillar 1 capital requirement of the portfolio concerned.

5. The calculation of the capital requirement for foreign currency risks as long as the volatile market conditions persist

In the HFSA's opinion foreign currency volatility continues to pose a degree of risk which credit institutions must continuously monitor and evaluate. The HFSA expects from the credit institutions in which a complex SRP is conducted that they use a more risk-sensitive method than the standard model and present such model in the course of the SRP.

With regard to credit institutions falling under the simplified and standard SRP - in accordance with Section 39 (3) of Government Decree 244/2000 (XII. 24.) - if the credit institution's open foreign currency position specified in this decree is higher than 2% of the institution's solvency capital before the deduction of any overrun, the institution is expected to apply the value-at-risk (VaR) model presented on the HFSA's website or an internal model developed by the institution.

The HFSA does not deem it necessary for cooperative credit institutions to mandatorily implement the above procedure as their risk is currently not significant in this respect.

The magnitude of the prescribed additional capital: when the complex SRP is conducted the size of the additional capital will be specified individually following the presentation and supervisory evaluation of the model applied. For credit institutions falling under the simplified and standard SRP, the additional capital is the difference in capital requirements between the value calculated by using the HFSA's VaR model and the regulatory value calculated by the institution in accordance with the provisions of Government Decree 244/2000.

6. Participation in financing venture capital funds

The operation of venture capital funds makes it possible, within the framework of the JEREMIE II programme, to utilise 70 % EU resources with the provision of 30% own resources for development purposes. The implementation of venture projects may carry significant potential advantages for the development of the Hungarian economy, however, losing the amounts invested to implement them is more probable compared to usual lending (the business plans reckon with the default of every fourth or fifth investment). The resources invested in venture capital funds are tied up for a long term by the credit institutions, their recovery can be expected after minimum 8-10 years. At the same time, this also represents profitability and liquidity risks on top of the credit risk. After purchasing venture capital bonds, there is a relatively small chance for the credit institution providing the self-funded portion to actively influence the risks of the transactions. Consequently, the HFSA prescribes, in a conservative manner, full capital coverage for the exposure of investments in long-term venture capital funds in order to protect the deposits (such risks may only be assumed by institutions which have adequate capital for the above without jeopardising the deposits).

The magnitude of the prescribed additional capital: the exposure must be covered in full by capital.

7. Repeated restructuring

Based on the experience of supervisory inspections, it occurs more and more often that certain transactions are repeatedly restructured, and no impairments complying with the portfolio's quality are made for these restructured transactions.[4] In the HFSA's opinion, such practice carries a significant risk for the individual institutions. Accordingly, it prescribes additional capital for transactions that have undergone contract amendment at least on two occasions since 1 January 2011 which amendment is aimed at restructuring (with the exception of participation in the government debt relief programme) and in which e.g. the credit institution grants additional grace period to the debtor for interest and/or principal repayment, however the increase in risk is not followed by increasing impairment.

The magnitude of the prescribed additional capital: 50-100% of the Pillar 1 capital requirement of the portfolio concerned.

8. Combined retail credit products

The HFSA finds those retail products that combine a certain form of saving (e.g. life insurance) with a credit type product risky from more than one aspect. The relevant financial institutions often do not possess up-to-date information on the debtor's ability and willingness to pay, thus the credit institution cannot take the necessary steps in the case of default or non-performance of the debtor. Further risk is seen by the HFSA if the currencies of the credit and the saving differ.

The magnitude of the prescribed additional capital: the HFSA prescribes additional capital requirement for combined retail credit product portfolio being formed following 1 March 2013, the magnitude of which shall be 50-100% of the Pillar 1 capital requirement of the relevant portfolio. Additional capital requirement is not applied to building society products combined with HUF based credit.

9. Retail credit portfolios originated by independent agents

On the basis of the information available to the HFSA it can be established that the proportion of retail credit portfolios more than 90 days overdue is much higher in the portfolios originated by independent agents than in the case of credits mediated by its own sales network. The HFSA's aim is that credit institutions use such measures when selecting independent agents and monitoring their activities, by which it can be ensured that the quality of the portfolio built this way, meets the requirement of the credit institution. Consequently, if the quality of the retail credit portfolios channelled through independent agents is lower (collectively rather than by individual intermediaries) than the quality of the institution's own retail portfolio, the HFSA expects the credit institution to set up additional capital.

The magnitude of the prescribed additional capital: 0-20% of the Pillar 1 capital requirement of the portfolio built by independent agents. The magnitude of the additional capital is prescribed on the basis of the quality of the control environment applied for engaging independent agents (pre-filtering agents, their training, backtesting, etc.).

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[4] The HFSA applies definitions for restructuring: as set out in Subsections 48 *a) and b)* of Section 2 of Government Decree 250/2000 (XII. 24.).