



## **VALIDATION GUIDELINES**

### **ON THE IMPLEMENTATION, ASSESSMENT AND APPROVAL OF INTERNAL RATINGS BASED (IRB) APPROACHES AND ADVANCED MEASUREMENT APPROACHES (AMA)**

#### **PART III CREDIT RISK MITIGATION TECHNIQUES, INTERNAL GOVERNANCE, PURCHASED RECEIVABLES**

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# 1 ON CREDIT RISK MITIGATION TECHNIQUES

## **Guidelines for the review of credit risk mitigation:**

1. Following the entry into force of the CRD and the respective Hungarian statutory regulations, institutions will continue to have the possibility to accept, in line with Hungarian statutory regulations and their own credit policies, collateral specified in their policies but not satisfying the criteria laid down in the CRD; however, only collateral meeting the CRD criteria can be used to mitigate the exposure value considered for the calculation of the capital requirement, and thereby to reduce the capital requirement.
2. In the course of a review conducted by the HFSA, it is up to the institution to demonstrate to the HFSA that it has adequate risk management processes to control risks arising from the use of collateral to mitigate credit risk, including residual risks, such as legal risk. Institutions must possess appropriately integrated management and control systems, valuation procedures, internal regulations and designated responsible persons to assure the prudent management of any risks that may arise.
3. Irrespective of whether the existence of credit risk mitigation was taken into account in the calculation of the risk weighted exposure and of the relevant expected loss, institutions must continue to perform the entire credit risk rating of the underlying exposures and they must demonstrate to the HFSA that their procedures are prudent. The review to be performed by the HFSA need not be limited to the examination of the application documents submitted by the institution; instead, additional documents may be requested or on-site investigations may be conducted.

## **The effect of the method used for the calculation of the risk weighted exposure on the type of collateral that may be used to mitigate credit risk**

4. The recognition of collateral for the purpose of credit risk mitigation depends on whether the institution intends to apply the Standardised or the IRB approach, and whether it uses a simple or complex approach to financial collateral.
5. The IRB approach allows the regulatory recognition of a broader range of funded credit protection as, in addition to the financial collateral eligible in the standardised approach or unfunded credit protection, acceptable collateral may also include lien on receivables, mortgage on real estate, mortgage on movable property as well as financial lease. Where the IRB approach is used, the expectations related to the collateral considered eligible under the standardised approach do not change, but the eligibility and minimum requirements are also applicable to additional eligible collateral as appropriate.

## **The simple and the complex method for the quantification of the risk mitigating effect**

6. Pursuant to the CRD and the Government Decree on the Management and Capital Requirement of Credit Risk (Government Decree 196/2007 – DCRR), when using the IRB fundamental approach the calculation of the capital requirement must always be carried out using the complex method for credit risk mitigation, because banks using the IRB approach are not allowed to use the simple method.
7. The complex approach reduces the exposure amount of the risk mitigant by taking into account the haircut (volatility adjustment factor) values. For the definition of the haircut, credit institutions must either use the value specified in the statutory regulation or they may estimate the value themselves using an internal model. The difference in comparison to the simple approach is that while under the simple approach the risk mitigant with its own risk weight replaces the appropriate proportion of the position to be covered, under the



complex approach the collateral may be used to reduce the exposure amount underlying the capital requirement calculation. As an additional difference between the simple and complex methods, while under the simple approach the maturity of the collateral may not be shorter than the remaining maturity of the exposure, under the complex approach the exposure and the collateral may have different maturities.

8. It should be noted that, as an alternative to using the volatility adjustments and own estimated volatility adjustments as defined in the Directive, institutions, with permission from the HFSA, may apply internal (VaR) models for repo-type transactions and securities or commodity lending operations implemented under standardised netting agreements.

#### **Funded and unfunded credit protection**

9. The Act CXII of 1996 on Credit Institutions and Financial Enterprises (ACI) and DCRR differentiate between two types of credit protection: funded and unfunded. By its nature, funded credit protection is a type of collateral that allows the institution to acquire the underlying asset or to seek satisfaction from the proceeds from its sale if a risk event occurs. In contrast, unfunded credit protection is a risk mitigation technique where the institution may seek satisfaction from an amount paid by an independent third party if a credit event occurs.

#### **Multiple protection for a single exposure, single protection for multiple exposures**

10. The CRD and the DCRR do not provide for priorities in the consideration of collateral where there are multiple protections for a single exposure or a single protection for multiple exposures. There are several different solutions in use in the banking practice to allocate exposures to collateral (such as proportioning or optimization). In the view of the HFSA, the institution may decide at its own discretion, within its internal regulations, on how and in what sequence multiple collateral should be considered. It should be noted, however, that the situation is more complicated if the intervals for the availability of collateral are different from each other and shorter than the maturity of the exposure.
11. It is important for the bank's system for the registration of collateral to ensure a solution for the tracking of the maturities of exposures and of collateral. If the maturities of exposures and of collateral are different, the system must provide a warning and, upon the expiry of the maturity of the collateral, it must automatically generate the alteration of the capital requirement calculation.

#### **The requirements of the CRD, the ACI and the DCRR concerning instruments for the mitigation of credit risk**

12. The regulation of funded and unfunded credit protection relies on Articles 91-93 of the CRD (Articles 76/E-76/F of the ACI) where, over and above the general expectations concerning collateral, the CRD and the ACI note that credit protection must also comply with the eligibility and minimum requirements set out in Parts 1 and 2 of Annex VIII to



the Directive and in the DCRR. However, the quoted provisions specify requirements for the recognition of instruments for credit risk mitigation in the calculation of the regulatory capital requirement as well as the methods for the quantification of the risk mitigation effect for credit institutions that apply the standardised approach or the internal ratings based approach (FIRB, i.e., not using own estimates or LGD and CCF). Pursuant to the interpretation of Article 91 (ACI Article 76/E Paragraph (2)), the credit risk mitigation techniques do not extend, or extend only with certain restrictions to exposures for which the institution makes its own LGD and CCF estimates (AIRB or retail exposures).

13. The CRD and the DCRR contain provisions for collateral for these cases as well, among the minimum requirements for the use of the IRB approach<sup>1</sup>, which will be presented at the respective chapters of these Guidelines. In this case, institutions need not fulfil the conditions specified in CRD Annex VIII Part 1 and in DCRR Chapter XIV for the recognition of collateral for the mitigation of credit risk, but they must fulfil the minimum requirements for collateral specified in CRD Annex VIII Part 2 and DCRR Chapter XV, as well as in the parts thereof related to the management of collateral, warranty to title and risk management, and they must have regulations for this.

### **The structure of the chapter**

14. The Chapter 'Credit risk mitigation techniques' discusses both funded and unfunded credit protection as follows.

General requirements concerning funded and unfunded credit protection<sup>2</sup>;

Eligible forms of collateral<sup>3</sup>;

Minimum requirements concerning the eligible forms of collateral and for collateral used with AIRB<sup>4</sup>, and their possible interpretation;

Overview of the relevant Hungarian regulations as to what requirements under Hungarian regulations must be considered in the use of recognised risk mitigation instruments, and to what extent the specific features of the Hungarian legal system could hinder the consideration of the specific collateral for the mitigation of the capital requirement.

These Guidelines do not cover the requirements for credit derivatives and netting, these topics will be added to these Guidelines at a later point in time.

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<sup>1</sup> CDR Annex VII Part 4 Sections 75-79 and 96-100, DCRR Article 74 Paragraphs (3)-(7) and Article 80 Paragraphs (1)-(7)

<sup>2</sup> CRD Article 92 Paragraphs 1 and 2, ACI Article 76/E Paragraphs (3)-(4)

<sup>3</sup> CRD Annex VIII Part 1, DCRR Chapter XIV

<sup>4</sup> CRD Annex VIII Part 2, Annex VII Part 4, DCRR Chapter XV



The purpose of this part of the Guidelines is to interpret the conditions of recognition for the mitigation of the capital requirement, to present the related expectations of the HFSA and to chart the effective statutory provisions that hinder or influence recognition.

## *General Requirements*

15. The approach used for credit risk protection, through the measures and steps taken and through the procedures and policies implemented by the lending credit institution, must result in valid and enforceable credit protection regulations in the governing jurisdiction. In other words, the contracts for credit protection must be legally valid and enforceable in a court of law. The concepts of legal validity/enforceability can be collectively referred to as **legal certainty**, meaning that the contract for credit protection complies with statutory regulations, is valid in every element and is enforceable in a judicial process. Legal certainty is a priority requirement for collateral, which not only features as a general requirement in the CRD and the DCRR, but is also prescribed in several places under minimum requirements. Consequently, we will only list the requirement of legal certainty under minimum requirements where regulations expound on its meaning in greater detail.
16. The institution must demonstrate to the HFSA that this requirement is satisfied by the credit protection it intends to use. One way to do this is to attach a legal opinion issued by a legal department sufficiently independent of other entities within the bank or by a third party lawyer or law firm, confirming that the credit protection proposed for use by the institution to mitigate credit risk complies with the requirements set out in the CRD and the DCRR. If the contract for collateral and its future enforcement are not governed by Hungarian law, a legal statement issued by a foreign or international law firm familiar with the institution must be provided in Hungarian or in English.
17. It is a requirement for issuers of all legal opinions related to collateral to be organizationally independent from the institution. A legal opinion issued by the legal department of the institution is only acceptable if the legal department is sufficiently separated and “independent” from the other organs of the institution.
18. The lending institution must take appropriate measures to assure the effectiveness of its credit protection policy and the management of the related risks. The eligibility of collateral is conditional on its registration at market value, its regular monitoring and its liquidity if required. These requirements are met, if the practice of the institution complies with the regulatory environment and if it is based on the enforcement of contractual discipline.
19. Institutional controls for the fulfilment of requirements for collateral considered for the mitigation of credit risk must be operated reliably, integrated into general credit risk management processes, and the procedures and processes must be adequately documented.

## **2 GENERAL REQUIREMENTS CONCERNING FUNDED CREDIT PROTECTION**

### **Liquid with Stable Value**

20. The institution must specify the definition of liquid collateral. The institution must be able to demonstrate that the market for the specific collateral is liquid, i.e., the collateral can be



mobilised. It is expedient to specify in internal regulations which specific markets the institution considers relevant with regard to the various types of collateral.

21. In its internal regulations the institution must specify the databases and the update methods used to maintain its valuations of collateral and of the changes in collateral data. The databases must be maintained to facilitate back-testing based on the actual figures (e.g., satisfaction from the sale of real estate by exercising a call option, or in an enforcement action). In its policies, the institution must provide for the real property admissible as collateral for liquidity purposes but not acceptable as a risk mitigation factor for capital calculation or acceptable only exceptionally, based on the assessment of other factors. For instance, commercial or residential real estate collateral owned by a third party, where the maintenance of insurance for acts of god represents increased risk, or residential property registered as a historic building where conversion is restricted, affecting its marketability. Such cases are to be assessed individually and to be treated separately on the level of the database and in the documentation.
22. The institution may liquidate the collateral – in the course of a judicial foreclosure or out of court – within a reasonable time or retain it if the obligor or the person providing the collateral is in default, insolvency or bankruptcy, or upon the occurrence of a credit event as agreed between the parties. In essence, this requirement aims to avoid a prolonged procedure for the enforcement of collateral to allow the creditor to receive the collateral within a reasonable timeframe. The collateral must be used in its entirety to satisfy the creditor.
23. We do not wish to provide an exact definition for timely liquidation; at this point it is necessary to investigate whether the contract includes any provisions that would hinder the enforceability of the collateral, and whether it contains all provisions that facilitate the same. With regard to the fact that the timely enforcement of collateral is significantly influenced by the system of competencies and responsibilities as defined precisely by the institution, the requirement cannot possibly be satisfied without these. Therefore, in addition to running through the legislative environment and the judicial practice, the satisfaction of this requirement will be verified by investigating the transaction terms and the internal procedures.

**A high correlation between the value of the collateral and the credit quality of the obligor is not allowed**

24. In this respect, the CRD and the ACI only mention that the value of the collateral may not show any material positive correlation with the quality (creditworthiness) of the obligor and, at the extreme, that securities of the obligor itself may not be recognised as collateral. A high positive correlation may exist if a deterioration in the credit rating, i.e. the risk position of the obligor entails a depreciation of the collateral and vice versa, if the depreciation of the collateral entails an increase in the credit risk of the borrower. Consequently, the institution must monitor any positive correlation between the credit quality of the obligor and the value of the collateral. In case of substantially positive correlation a reduction in capital may not be recognised.

## ***2.1 Eligibility and Minimum Requirements for Financial Collateral***

### **2.1.1 Eligible Financial Collateral**

25. Financial collateral eligible under all approaches
  - 1) Cash and cash equivalents (deposits under the DCCR);
  - 2) Debt Securities issued by



- Central governments and central banks;
- - Regional governments or local municipalities; and
  - Public sector entitieswith risk weights identical to the central government;
- - Multilateral development banks;
  - International organizationswith risk weights of zero percent;

rated according to the credit rating described in CRD Annex 8 Part 1 Section 7/b and DCRR Article 100 Paragraph (1) b);

- 3) Debt securities issued by institutions, or regional governments, local municipalities or public sector entities with identical credit weights, rated according to the credit rating described in CRD Annex 8 Part 1 Section 7/c and DCRR Article 100 Paragraph (1) c);
- 4) Debt securities issued by multilateral development banks defined in DCRR Article 7 Paragraphs (1) and (4) and rated according to the credit rating described in DCRR Article 100 Paragraph (1) c);
- 5) Debt securities issued by enterprises and rated according to the credit rating described in CRD Annex 8 Part 1 Section 7/d and DCRR Article 100 Paragraph (1) d);
- 6) Shares or convertible bonds included in stock market indexes;
- 7) Gold;
- 8) Non rated securities issued by institutions, if they are listed on a recognised exchange and qualify as non junior debt, and if all other issues by the issuing institution satisfy the rating criteria under CRD Annex VIII Part 1 Section 8 c) and DCRR Article 100 Paragraph (2) c), and there is no information to suggest that the rating of the security would not reach a minimum level and if it has sufficient market liquidity.
- 9) Investment units of investment funds with public daily quotes, invested in eligible assets or in eligible derivatives for hedging purposes as specified above.

26. Additional collateral admissible according to the Financial Collateral Comprehensive Method

- 1) Equities or convertible bonds, not included in a stock exchange index but traded on a recognised exchange;
- 2) Investment units of investment funds with public daily quotes, invested in eligible assets or in eligible derivatives for hedging purposes as specified above.

27. Of financial collateral, the supervisory recognition of external rating institutions has fundamental importance for the eligibility of securities. The ACI and the DCRR define the



process for the supervisory recognition of credit rating organizations and their publication (see the homepage of the HFSA).

## 2.1.2 Minimum Requirements for Financial Collateral

### Correlation

28. The general requirement for funded credit protection (a high positive correlation between the rating of the obligor and the value of the collateral is not allowed) is specifically emphasized for financial collateral. Consequently, institutions must have procedures for the monitoring and screening of positive correlation. Covered bonds issued by the obligor, which can be recognised as collateral for repo transactions, represent an exception to this rule<sup>5</sup>. However, the requirement for the correlation to remain insignificant still applies.

### Legal Certainty

29. This requirement essentially corresponds to the legal certainty requirement described under general requirements. It also includes the requirement for institutions to regularly assess the legal enforceability of collateral at least once every year. The relevant internal procedures must designate a responsible person for performing the assessment and a definition of his duties. The legal department of the institution must always be involved in the regular monitoring of collateral, in case the responsibility is not delegated to the legal department.

### Operational Requirements

30. **Adequate documentation of collateral.** This requirement means that institutions must file and maintain records of all collateral related to the individual credit transactions, all changes in the value and enforceability of such collateral (the results of the regular collateral reviews as mentioned in the previous paragraph), as well as all documents acquired in order to establish the eligibility of such collateral.
31. **Control of risks.** Risks arising from the use of financial collateral must be controlled and supervised. Early detection of a reduction or deficiencies in collateral, or the identification of a dangerous concentration of a type of financial collateral accepted, is only possible with regular monitoring. Acceptable levels of concentration or the acceptable reduction of collateral, as well as the levels considered dangerous, must be specified in advance in the internal rules of the institution. It is expedient to include the rates and limits in a table.
32. **Procedures and Regulations** governing collateral and amounts accepted. The internal regulations must describe the types of collateral the institution intends to accept in respect of the various products or transactions.
33. **The Calculation of the market value of collateral** and its regular re-valuation (at least once every six months). The valuation of financial collateral must be performed in a way suitable for identifying its objective market value. We should highlight, however, that compliance with the requirements of the CRD and the DCRR requirements may easily

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<sup>5</sup> CRD Annex VI Part 1 Sections 68-71, DCRR Article 14



become disputed both in terms of the interval (frequency of valuation) and the value (decline in market price), because any material change – significant drop - in market prices is subject to a subjective judgment, therefore the internal regulations can be expected to provide a detailed specification and reasoning for the procedure used. The regulations of the institution must also specify the people responsible for establishing the market value of collateral and the procedures to be followed. Based on the regulations, the conditions regulating the cooperation of the client and the institution must also be recorded.

34. If financial collateral is kept with a third party, there should be proof that it is handled separately from the assets owned by such third party and the credit institution must take all necessary measures to ensure this. Proof for the fulfilment of the above requirement must be based on the fact that the institution can take timely measures to block the collateral or to prevent any encumbrance or access by another party. Unexpected situations may arise in the case of non-blocked types of collateral (simple bank deposits) if the third party becomes insolvent. In order to clearly measure this and to minimize risk, the third party must be examined (e.g., simplified risk assessment, obtaining its external rating) before any financial collateral is deposited. The HFSA may request the institution to submit the documentary proof thereof.

### 2.1.3 Overview of the Hungarian Regulations Applicable to Financial Collateral

35. Financial collateral corresponds to the legal concept of security deposit in the Hungarian legal system. Paragraph (1) of Article 270 of the Civil Code allows cash, funds on bank accounts and securities to be used as security deposits. The factors constraining the recognition of security deposits as instruments for credit risk mitigation are described below.
  - Pursuant to Paragraph (1) of Article 271 of the Civil Code, there are **certain conditions** to be met for the beneficiary to be able to satisfy his claim directly from the security deposit once he acquires the right to satisfaction (such as, if the security deposit is in the form of cash, funds on a bank account, a security with a price quote on a public market or with a price that can be established independently of the parties, or some other financial instrument). Pursuant to the same section of the Civil Code, if the aforementioned conditions are not satisfied, the beneficiary is only entitled to exercise his right to satisfaction if this is explicitly contained in a relevant clause or if the valuation method is specified in the contract. Therefore, when specifying the contents of security deposit agreements, the institution must observe the aforesaid rules in order to assure fast and direct satisfaction.
  - Paragraph 5 of Article 38 of the **Bankruptcy Act** provides favourable treatment to the beneficiary of the security deposit in a liquidation procedure, because the beneficiary may satisfy his claim from any security deposit provided prior to the start date of the liquidation procedure, irrespective of the commencement of liquidation proceedings. However, the aforementioned section of the Bankruptcy Act leaves only three months for this option to remain open; following which the beneficiary of the security deposit may claim satisfaction only as a beneficiary of a lien, therefore the institution must make sure to satisfy its claim within 3 months from the initial date of the liquidation proceedings against the obligor. There are further constraints to be observed for **local government obligors**, because pursuant to Paragraph (1) b) of Article 31 of Act XXV of 1996 on the Procedures for the Settlement of Local Government Debt, claims secured with a security deposit are ranked second most senior (following the payment of regular payroll expenses), provided that the security deposit was secured at least 6 months before the initial date of the debt settlement procedure. Therefore the general CRD/DCRR requirement (that the Bank should be able to liquidate the collateral in due time in the event of the insolvency or bankruptcy of the



obligor) is not always satisfied. Thus, when accepting financial collateral from a local government, these circumstances should be considered when establishing the value of the security deposit and for the risk management approach.

- The position of the beneficiary of the security deposit may be weakened by Section c) of Paragraph (1) of Article 40 of the Bankruptcy Act, which provides a right to challenge any contract or other legal representation of the obligor concluded within 90 days prior to the receipt of the application to initiate a liquidation procedure or thereafter, if the contract or representation is aimed at providing preferential treatment to a creditor, in particular the amendment of an existing contract to the benefit of the creditor or the provision of protection to a creditor holding collateral. According to the commentary to the Bankruptcy Act, the interpretation of Section c) of Paragraph (1) of Article 40 is in dispute. Under a possible interpretation, Section c) refers to so-called “in fraudem creditorum” procedures, i.e., transactions involving the collusion of the insolvent obligor and a mala fide third party in order to defraud creditors. Under another view, Section c) does not necessarily refer to so-called “in fraudem creditorum” procedures; instead, it appears that it also provides a basis to challenge any transaction between a bona fide third party and the insolvent obligor, if it qualifies as an attempt by the obligor to defraud creditors by reducing the estate of the obligor. Under the latter interpretation, a contract for security deposit could be challenged pursuant to Section c) of Paragraph (1) of Article 40 if the security deposit was provided within 90 days prior to the receipt by the court of the application, because the transaction obviously reduces the estate of the obligor, which may have been aimed at defrauding the other creditors of the insolvent obligor. This circumstance in itself does not hinder the eligibility of financial collateral, but it must be coupled with appropriate risk management.
- The beneficiary of the security deposit has a favourable position **in the foreclosure procedure** because, on the one hand, pursuant to Article 75/D of the Judicial Enforcement Act, funds under separate management for purposes of transaction collateral managed by a financial institution, owing to an obligor but removed from his discretionary powers, may be subjected to foreclosure only for claims related to such specific purpose or arising from such specific transactions. On the other hand, pursuant to Article 96/A of the Judicial Enforcement Act, upon the request of the obligor or of the beneficiary of the security deposit, cash, savings books or securities provided as security deposits must be **exempted** from foreclosure by the bailiff for as long as the conditions for the return of the security deposit are not met. On this basis however, the institution must request in the course of the foreclosure the exemption from the foreclosure of the cash or security serving as security deposit. It should be noted, that the preferential treatment of the beneficiary of the security deposit pursuant to Section 79/D of the Judicial Enforcement Act applies only to security deposit in cash, while the security deposit may also take forms other than cash. Therefore, if the security deposit takes the form of a security, its exemption must be requested separately. The institution must have the necessary information and operational conditions to be able to take the necessary steps in time and with legal validity.
- Nowadays, the offer of securities as security deposit typically relates to dematerialised securities. In this case, the party maintaining the securities account transfers the securities to a securities sub-account pursuant to Paragraph (1) of Article 144 of the Capital Market Act. In this case he must observe the provisions of Article 144 of the Capital Market Act.



## 2.2 *Eligibility and Minimum Requirements for Real Security on Real Property*

### 2.2.1 Eligible Real Estate

36. Both residential real estate (in which the obligor resides, will reside, or which the obligor lets or will let) and commercial real estate are eligible. The concept of residential property is provided by the DCRR only under exposure grades secured by real property, which however we consider as authoritative in this case. Pursuant to that, property is eligible if it is residential property as defined in Paragraph (4) of Article 147 of Act LIII of 1994 on Judicial Execution (hereinafter: residential property). Accordingly, to be eligible as residential property, the property must have been established for the purpose of dwelling and must be registered in the land registry as a house or flat for dwelling. In order for real property to be recognized for credit protection, both conditions must be satisfied (while an issued occupation permit in itself is not sufficient).
37. The value of the property as collateral and the rating of the client are independent of each other.
38. The counterparty risk does not depend substantially on the capacity of the underlying property or project. The legislator defined “substantially” as 80%, i.e., the repayment of the obligation should be dependent to at least 80% on revenue not related to the real property<sup>6</sup>. In essence, this provision requires that the repayment of debt in itself may not be substantially dependent on any cash flows generated by a real estate underlying the collateral, or else the primary and secondary “collateral” for the loan would be identical. In the course of the assessment of the counterparty risk, only factors other than the capacity of the property or project underlying the collateral can be taken into consideration. This requirement also means that there is no positive correlation between the counterparty rating and the value of the credit collateral. One example for positive correlation is where a substantial part of the cash flow involved in repayment is derived from the rent, with no other related service attached.
39. Hungarian regulations do not allow for the exercise of discretion, allowed for competent authorities under the CRD, to dismiss the application of the condition set forth in the previous paragraph if the member state where the property is located has a traditionally developed real estate market characterised by sufficiently low rates of loss. Neither have other discretionary powers been exercised, as allowed under the CRD for real property classified as non residential. Correspondingly, institutions are advised to develop risk management procedures and to specify in regulations that they will examine when disbursing credit and during the entire term of the loan, whether the client has available funds for the fulfilment of the obligation, in addition to the cash flow derived from the real property,

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<sup>6</sup> DCRR Article 103 Paragraph (1) Section b)



and whether not more than 20% of the repayment is made using cash flow derived from the real property.

## 2.2.2 Minimum Requirements for Real Property

### Legal Certainty

40. The legal certainty specified as a general requirement for collateral is defined specifically for real estate under minimum requirements. The contract must contain all provisions that allow the enforceability of the collateral and its realisation within an appropriate timeframe. In the case of real estate, the principle of legal certainty is supplemented with the requirement of the appropriate and timely registration of mortgages. The agreement must reflect an effective mortgage (it must satisfy all of the substantial and formal requirements for a mortgage).

### Regular Valuation of the Collateral

41. Establishing the value of the security deposit: although it is not included among the minimum requirements, the provision of Paragraph (1) of Article 146 of the DCRR is nevertheless of fundamental importance for establishing the value of real property, stating that if the IRB method is used, the value of real property must be appraised by an independent appraiser of real property, and it may not exceed the market value<sup>7</sup>.
42. The value of real estate must be examined frequently, at least once a year in the case of commercial property and at least once every three years in the case of residential property. More frequent reviews are necessary if the real estate market is subject to substantial changes (the Hungarian real estate market is currently not considered as such, thus the base-case review intervals are acceptable). Statistical methods may be used for the review of the value of real estate and to specify which real estate properties should be revalued. Various statistical methods are acceptable for the review of the value of real estate collateral if there are appropriate databases available (which may also be external “purchased” databases) corresponding to the portfolio of the credit institution, if the methodology used is professionally well-founded and adequately documented, and if it has proven and adequate predictive capabilities.
43. We expect that the use of the statistical method will not be possible in Hungary for commercial real estate, because the conditions for numerosity and comparability, as required for the statistical method, can not be fulfilled. The use of a database could still be allowed, if there is an appropriate number of data series of appropriate length available (the term “appropriate number” is subjective, but an indicative number, allowing for deviations if justified, could be a database covering more than 70% of the commercial real estate properties within a given settlement or region). In all other cases individual market valuations must be used.

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<sup>7</sup> CRD Annex VIII Part 3 Section 62



44. If there is information available to indicate that the value of the real property may decline significantly as compared to the general market price, and in the case of loans exceeding EUR 3,000,000 or 5% of the credit institution's solvency margin, the property review mentioned in the previous paragraph must be performed by an independent real estate appraiser. An "independent real estate appraiser" is a person who has the qualifications, skills and experience necessary for performing an appraisal, and who is independent of the process related to the lending decision.
45. If there are several exposures related to a real estate collateral, the above limits of EUR 3,000,000 or 5% of the institution's solvency capital must be considered for the aggregate total of all exposures, since the risks related to the real estate may influence all exposures at the same time. The situation is different if there are exposures, vis-à-vis an obligor or a group of obligors, in aggregate exceeding 5% of the solvency capital which are secured by distinct real estate properties, because these can be considered separately from each other.
46. With respect to the condition under Section 44, the HFSA expects the internal rules of the institution to address the following issues:
- The principles and techniques of assessment, i.e., what the institution considers to be a material change in market conditions or a material decline in the value of the property as compared to the market price, and an increase or decrease relating to which period or which data scope is to be considered material (e.g., a 10%/year decline may be material and it may affect the ability to mobilise);
  - Demonstration of the soundness and appropriateness of valuation methods;
  - The data scope or the method based on which the collateral value is established at the time of the assessment or the undertaking of risk (individual assessment or statistical data base). In case of a real property, the value of the collateral is the market value or less or, if the country concerned has legislation concerning the mode of the establishment of the mortgage collateral value, the mortgage value or less.<sup>8</sup> At the same time, when establishing the collateral value, the experience obtained in the course of the review of the real estate property value must be considered, as well as any senior claims on the real estate that should be used to reduce its market value or mortgage collateral value.
  - If external databases are used, the name(s) of the database(s) used and their update arrangements (duty office, land registry, databases of realtors, own database, etc.);
  - Over and above the normal review, the cases of extraordinary real estate review;
  - The rules for on-site inspection and assessment (depending on the value of the property and on other factors). The statutory requirement to review the value of commer-

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<sup>8</sup> Pursuant to Paragraph (4) of Article 5 of the Mortgage Act, credit institutions engaged in mortgage lending must have regulations for the determination of loan security values, and these regulations must be prepared pursuant to Decree 27/1997 (August 1) issued by the Minister of Finance on the methodological principles for identifying the loan security values of real estate properties not classified as arable land.



cial property at least annually and the value of residential property at least every three years does not mean compulsory on-site revaluation. However, the institution may require on-site revaluation, and must regulate the applicable cases in its internal regulations;

- The data series used to establish market prices, as well as the institution's definition of a comparative data set (e.g., in respect of location, property type).

47. In the context of market valuation, the minimum documentation requirements are as follows:

- In case of the valuation of collateral relating to obligor rating, the clear indication of the above data source;
- Indication of the date of the next review as part of the rating;
- The collateral agreement – or if it is part of the credit agreement, then the part relating to collateral – should contain provisions concerning the obligation of the borrower to cooperate in performing the market valuation (e.g., providing for on-site survey, inspection, and access by the institution or its representative);
- The frequency of database updates and a description of its sources;
- Documentation of the market value of individual properties as determined by the review;
- In case if collateral is enforced, the institution must demonstrate that the above calculations were used for the recovery of the claim.

#### **Clear Documentation**

48. The types of residential and non residential properties accepted by the institution as well as the credit policy of the institution in this respect must be clearly documented.

#### **Insurance**

49. The real property offered as collateral must be adequately insured against losses. The institution must determine, depending on the type of the property and the magnitude and term of the exposure, what kind of protection it requires against losses and other insurance events. The minimum requirement concerning insurance is to require continuous insurance coverage during the term of the claim, or any potential alternative arrangements for this (e.g., assumption of premium payment or lump-sum up front payment).

#### **2.2.3 Overview of the Hungarian legislation governing mortgage on real estate**

50. Under Hungarian law, real estate may be subject to collateral in the form of a mortgage, frame mortgage or independent lien.

51. The CRD requirement that there should be proper and timely recorded (under the CRD the contract must ensure a 'perfected' lien, i.e., all legal requirements for establishing the mortgage must be fulfilled) means, in the interpretation of the HFSA, that the mortgage established on the real property can be accepted as an instrument for credit risk mitigation if the constitutive registration of the mortgage has been completed (pursuant to Article 262 of the Civil Code and Paragraph (2) of Article 3 of the Real Estate Registration Act, the mortgage is created with its registration). In the process of real estate mortgage registration in Hungary, as long as the title is recorded only as a side note on the title deed, institutions are not allowed to take into consideration the mortgage collateral for the calculation of their solvency capital (thus this does not prevent the extension of credit and the acceptance of the property as collateral, but the collateral may not be used to reduce the capital requirement until the registration is completed).



52. The requirement of **legal certainty** is affected inasmuch, that the agreement must be concluded in the form and with the content that will enable its registration in the land registry. The formal and substantial requirements set out in Section 31 of the Real Estate Registration Act must be observed in the contracting process. Namely, if the contents required under the Real Estate Registration Act are missing, the contract will still be valid under civil law, but it will not be suitable for registration in the real estate register.
53. Furthermore, the position within foreclosure of the mortgagee of the real estate mortgage may also affect the requirement of **legal certainty**. Pursuant to Paragraph (1) of Article 136 of the Judicial Enforcement Act, real property owned by the obligor can be subjected to foreclosure irrespective of its nature, type of utilisation or rights or constraints encumbering the property or the facts relating to the property as recorded in the property register. Paragraph (1) of Article 137 of the Judicial Enforcement Act provides for the rights that may restrict the ownership title of a new owner acquiring a property subjected to foreclosure, but this listing does not include mortgage. Within the framework of a foreclosure the seizure of property occurs with the registration of foreclosure rights, of which the mortgagee is also notified pursuant to Paragraph (2) of Article 138 of the Judicial Enforcement Act. The mortgagee may participate in the foreclosure pursuant to Article 138/B. However, Article 114/A of the Judicial Enforcement Act provides that the mortgagee may join the proceedings only if the legal basis and the amount are not disputed by the obligor or the person requesting the foreclosure. If, however, the legal basis or the amount is disputed, the mortgagee may only enforce his claim arising from the mortgage in court proceedings, which renders the timely realisation of the collateral questionable, because on this basis the mortgagee may actually only gain access to the collateral following protracted litigation. This is resolved by the rule set out in Paragraph (4) of Article 114/A of the Judicial Enforcement Act, whereby neither the legal basis nor the amount may be disputed if they have been recorded in a public instrument. On the basis of the above, the HFSA considers enforceability within a reasonable time ensured, if there is a contract about the claim and the collateral recorded in a public instrument. In essence, an identical effect is achieved by a unilateral statement of obligation made by the obligor and recorded in a document notarized by a public notary, to fulfil his obligations as an obligor on the basis of the contract, and to fulfil his obligations as a mortgagor (and within this to tolerate the exercise of satisfaction rights by the mortgagee from the object of the mortgage). If the obligor and the mortgagor are not the same person, the mortgagor must also make a statement of obligation recorded in a document notarized by a public notary, to fulfil his obligations as a mortgagor and within this to tolerate satisfaction from the pledged property.
54. If the property is sold in auction and, pursuant to Paragraph (1) of Article 151 of the Judicial Enforcement Act, no mortgage is retained on the property after that, then pursuant to Paragraph (1) of Article 170 of the Judicial Enforcement Act, certain claims (such as for alimony, wages, etc.) shall be senior to the satisfaction of the mortgagee.
55. The satisfaction of the mortgagee is also endangered by the fact that, pursuant to Paragraph (4) of Article 156 of the Judicial Enforcement Act, it is possible in an auction to reduce the price to half of the property's estimated value, or in case of a residential property, to 70% of its estimated value.
56. With regard to **direct enforceability**, as the general rule, pursuant to Paragraph (1) of Article 252 of the Civil Code, a mortgage can only be enforced by way of foreclosure subject to a court ruling. Departure from this rule is not possible even with the mutual consent of the parties, because pursuant to Paragraph (2) of Article 255 of the Civil Code, any agreement concluded before the devolution of the right of satisfaction and under which the mortgagee obtains the title to the pledged property if the obligor fails to meet his obliga-



tion shall be null and void. However, pursuant to Paragraph (2) of Article 257 of the Civil Code, if the mortgagee engages in mortgage lending on a commercial basis, the parties may agree in the contract – by specifying the minimum sale price, its mode of calculation and the deadline from the devolution of the right of the mortgagee to satisfaction – to allow the mortgagee to sell the pledged property himself, without resorting to judiciary foreclosure.

57. As another option, the institution may agree with the obligor to sell the pledged property together, which is possible pursuant to Paragraph (1) of Article 257 of the Civil Code, with the terms and conditions specified therein. However, the deadline for the joint sale of the pledge property must be limited. In view of this, therefore, the requirement of direct enforceability is met only if the institution concludes a mortgage agreement with the client that specifies that upon the devolution of the right of satisfaction, the mortgagee itself, or in conjunction with the obligor, has the right to sell the pledged property. This provision is also important because, pursuant to Paragraph (1) of Article 258 of the Civil Code, the credit institution is also entitled to transfer the title to the pledged property on behalf and in the name of its owner. If he is not in possession of the pledged property, he may also request that it be surrendered for the purpose of a sale.
58. On the other hand, when determining the time limit for the sale of the pledged property by the institution itself, the parties must consider that pursuant to Paragraph (1) of Article 257 of the Civil Code, the agreement for joint sale loses effect if the deadline expires without a successful sale.
59. It is important to discuss **independent lien**, which Hungarian credit institutions customarily use under refinancing arrangements. This arrangement is based on the framework agreement between the mortgage bank and a lending institution for the purchase of independent liens.<sup>9</sup> The agreement for the establishment of independent lien is part of the credit agreement between the lending credit institution and the borrower. Following this, the mortgage bank purchases the independent lien from the credit institution, and concurrently the credit institution repurchases it from the mortgage bank. The Mortgage Act imposes important substantial and formal requirements in respect of such transactions, therefore if they are not satisfied, the legal transaction is invalid, and consequently the legal certainty requirements are not satisfied. In view of this, pursuant to Paragraph (4) of Article 8 of the Mortgage Act, the conditions laid down in Paragraph (2) of Article 8 and Paragraph (4) b) of Article 8 of the Mortgage Act must be observed. If the lending credit institution for any reason fails to pay the repurchase price once it becomes due, pursuant to Paragraph (6) of Article 8 of the Mortgage Act the credit secured by the independent lien shall assign to the mortgage credit institution as a legal assignee.<sup>10</sup> With regard to the mapping

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<sup>9</sup> It is to be noted that mortgage banks involved in such arrangements receive interest subsidies from the state pursuant to Section b) of Paragraph (5) of Article 12 of Government Decree 12/2001 (January 31) on housing subsidies provided by the state to mortgage banks.

<sup>10</sup> As of this point in time the mortgage credit institution becomes not only the beneficiary of the independent lien and the prohibition of transfer or encumbrance, but at the same time it also becomes the beneficiary of the primary claim.



of transactions for the refinancing of mortgages with the purchase of independent liens to transaction categories, Paragraph (9) of Article 12 of the DCRR provides that mortgage credit institutions may map claims for the repurchase price of independent liens on real property to the category of exposures secured by real estate, if the independent lien serves as collateral for claims that meet the requirements as defined there. If the IRB method is used, the mortgage credit institution may recognize a real security on the real estate property as credit protection related to its claim, if the eligibility and minimum requirements specified under Chapters XIV and XV of the DCRR, and applicable to the real estate property as an instrument of credit protection, are met.<sup>11</sup>

60. In order to fully satisfy the requirement set out in the CRD/DCRR, institutions must strive to secure a first mortgage. If the mortgage is not a first mortgage, the real estate can be taken into account for the reduction of the capital requirement only if the value of the property had been encumbered by the preceding mortgages to an extent not exceeding the level determined in the regulations of the institution. If an encumbered real estate is accepted as collateral, the minimum requirement of the CRD/DCRR must be observed whereby any priority claims on the property must be taken into account when establishing the collateral value, and should be used to reduce the market value or the mortgage collateral value. Within their regulations, institutions must provide for the conditions and procedural order for the acceptance of mortgages that are not first mortgages.
61. It should be noted that pursuant to Paragraph (4) of Article 262 of the Civil Code, the owner may also have a side note entered into the real estate register that he intends to encumber the real property within a year with a mortgage in an amount not exceeding the sum specified in the side note. If the registration of the mortgage is requested within the time limit specified in the side note, the mortgage will be given a priority corresponding to the priority (rank) of the side note. If justified and in order to secure a first priority mortgage, it may be expedient, when a credit application is submitted, to require the owner to procure such a side note to be made.
62. In the Hungarian practice institutions usually request the land registry to register a prohibition of alienation and encumbrance or a prohibition of alienation only. Pursuant to Paragraph (2) of Article 114 of the Civil Code, the right to alienation and encumbrance may only be restricted or prohibited when ownership rights are transferred, and only with the purpose to secure the rights to the property of the transferring person or some other person. In the case of a real estate property, the land registry must also record the rights that are to be secured by the prohibition. Therefore, the institution can only stipulate the above, if the loan is connected with a transfer of ownership rights to the real estate property.
63. Pursuant to Paragraph (2) of Article 5 of the Mortgage Act, a prohibition of alienation and encumbrance on a real estate property encumbered with the mortgage (independent lien) of a mortgage credit institution, must be registered in the land registry with the registration or transfer of registration of the mortgage (independent lien) to the benefit of the mort-

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<sup>11</sup> DCRR Article 103 Paragraph (2)



gage credit institution, even if a corresponding separate request is not made, and if this is not done, the beneficiary may not enforce its rights vis-à-vis a bona fide third party acquiring rights on the real estate property. Therefore, in the case of a mortgage credit institution, the registration of the prohibition of alienation and encumbrance must be verified, and the relevant regulations must specify the person responsible for the verification.

64. Under the effective regulations, the legal enforceability of collateral in a liquidation procedure depends on its recognition by the liquidator (creditors have 40 days from the ruling on liquidation becoming final to state their claims), institutions must therefore monitor whether liquidation procedures have been initiated against their obligors, and if yes, they must observe the 40 day deadline for stating their claims. Otherwise, the commencement of liquidation proceedings against the obligor may violate the principles of direct satisfaction or of access to the collateral value within a reasonable time. The HFSA recommends that in addition to subscribing to the Corporate Gazette (Céghírnök) service, institutions should also oblige their obligors to notify them if liquidation proceedings are initiated against them.
65. Pursuant to the amended version of the Bankruptcy Act, effective as of 1 January 2007, if the lien was created before the commencement of liquidation, the liquidator may only deduct from the proceeds of the sale of the pledged property the costs of its safekeeping - including the preservation of its condition - and the costs of its sale, as well as the liquidator's fees as specified in separate statutory regulations. Any remaining amounts must be used, without delay following the sale of the pledged property, to satisfy the claims secured by the pledge encumbering the pledged property, observing the priority sequence as specified under Paragraph (1) of Article 256 of the Civil Code. This amendment has removed one of the major obstacles to the eligibility of real property collateral, but because there are still some remaining expenses (such as the costs of sale or the fees of the liquidator) that still rank higher than the satisfaction of the lien holder, and because the aforementioned provisions of the Judicial Enforcement Act may hinder the enforcement of the collateral, institutions must specify the recognizable portion of their real property collateral on the basis of their historical experience. It should be noted that the 50% limitation on satisfaction currently existing under the Bankruptcy Act but abolished in respect of other pledges with the amendment of the Bankruptcy Act effective 1 January 2007, will continue to be in place for liens on assets, and thus liens on assets – in addition to not being identified by the DCRR as eligible credit protection – are also not eligible as collateral according to the position of the HFSA.

### ***2.3 Eligibility and Minimum Requirements for real Security on Receivables***

#### **2.3.1 Eligible Receivables**

66. Under the CRD and the DCRR, receivables are eligible as credit protection if they are related to a commercial service or a transaction or transactions with an original maturity not exceeding one year.
67. On the basis of the above, the establishment of eligibility requires the ability to clearly identify, within the registration of collateral, the underlying transaction related to the specific receivable. If the underlying transaction is not a commercial service, the delivery deadline for the underlying contract (this is not the due date for payment!) may not exceed one year.



68. In order to recognize receivables as credit risk mitigation, the institution must ensure the concordance of the maturity of the credit and the due date of the receivable, to be investigated and confirmed as follows:
- If the due date of the receivable is the same as the maturity of the credit, the receivable collected serves to repay the outstanding credit;
  - If the due date of the receivable precedes the maturity date of the credit, and it is collected by the institution, the institution is allowed, pursuant to the terms previously established in the credit agreement, to collect the receivable serving as collateral and to offset it against the credit receivable when it falls due. During such term, the money collected by the institution may bear interest, the rate and beneficiary of which is subject to agreement;
  - If the due date of the pledged receivable is later than the maturity date of the credit, as a general rule, such receivable may not be considered as credit protection because there is no receivable due at the time of the maturity of the credit and thus the requirement to collect the claim on time can not be met. Such receivables may be considered if the institution can certify the on-time collection of the receivable.
69. Receivables must be independent, i.e., not involved in other transactions, thus receivables related to securitization, non-qualifying holdings or credit derivatives can not be accepted. In addition, recognized receivables may not include any claims related to enterprises closely related to the client.

### 2.3.2 Minimum Requirements for Receivables

#### Legal Certainty

In addition to the conditions presented under general requirements, statutory regulations also set the following requirements for receivables:

70. Based on the collateral, the institution must be able to dispose over the receivables clearly and efficiently;
- The HFSA considers this requirement fulfilled if the receivables considered for credit risk mitigation by the institution are such, where the financial claims are locked up following delivery on the underlying transaction, but before the due date for the payment obligation. Without this, one can only talk about claims that will be created in the future and which are not yet in existence (or at least not clearly) at the time of the lock-up. If the credit institution only accepts receivables that meet this requirement, it can concurrently exclude the risk of non performance, which could be a significant obstacle not only to efficient disposal over the collateral, but also to the efficiency and speed of enforcement.
  - It is also a condition for the party with the payment obligation in the underlying transaction to accept the performance as well as his payment obligation. Departure from this provision is possible in exceptional circumstances only if the institution can demonstrate that it has examined both the performance obligation and payment obligation related to the commercial transaction and has sufficient knowledge and experience with regard to both. Based on this, performance risk and non-payment with reference to non performance can be excluded or minimized, the party obliged to make the payment is ready to pay.
  - The contract for the collateral must ensure clear rights for the lender to dispose over the revenues. The pledged receivables must be in existence and must be precisely defined with regard to performance; amount, currency, payment terms and due date. Receivables may not be accepted as credit risk mitigation if the person obliged to pay



has not waived his right to offset payables against claims from the obligor of the lien, because in this case the amount of the receivable is not precisely specified.

- In order to ensure effective disposal over the receivable, the obligor of the receivable must acknowledge and accept that the receivable is being pledged to the credit institution and that subsequently the payment can only be made to a bank account isolated to the benefit of the credit institution. To ensure effective settlement the conditions for the enforcement of the collateral must be defined clearly (such as the settlement day, the conditions for the termination of the contract and the circumstances for the enforceability of the collateral);

71. Credit institutions must take all steps necessary under the applicable law to ensure that the protection can be enforced prior to all other claims. On the one part, this includes the requirement for the credit institute to enjoy priority in satisfaction ahead of all other creditors in the case of a liquidation of the obligor. The legislative basis for this is created by the Bankruptcy Act, because if the lien was created prior to the start date of the liquidation procedure, the liquidator must pay the amount received from the sale of the collateral to the beneficiary of the lien, and is only allowed to deduct the liquidator's fees as specified in statutory regulations, and the expenses related to the safe-keeping of the pledged property, the preservation of its condition, and its sale. If there are several beneficiaries, payment is made in the sequence of the creation dates (ranks) of the liens. On the other part it includes the requirement for the credit institution to have a first lien on the receivable. In order to enable the identification of ranking and satisfaction priorities, the lien of the credit institution must be registered in a registry maintained by a Hungarian National Chamber of Public Notaries (MOKK), as this is the only way for the condition to be met. Without this the receivable is not eligible as credit protection.
72. The credit institution must confirm, at least once every year, in the framework of a legal review, that the contracts comply with statutory regulations and consequently they can be executed, the collateral is enforceable. The legal review must be performed regularly, must be regulated and adequately documented.
73. To ensure direct access if a credit risk event occurs, the credit institution must have the right to sell or assign the receivable to another party without the consent of the obligor. If the receivable offered as collateral is aimed to provide a tangible property, then these clauses must be contained in the contract.

#### **Appropriate Risk Management**

74. The credit institution must examine the business of the borrower. This process shall include the analyses of the borrower's business and industry, expected ability and willingness to pay and its relationship with its business partners (who the partners are and how durable the relationships are, etc.).
75. Furthermore, within the framework of risk management the institution must investigate the business practices of the obligor of the receivables used as collateral, his ability and willingness to pay, which must be assessed subject to the institution's regulations for obligor rating. Within its regulations the credit institution must address the minimum obligor rating required of the obligor at the time when the receivables are pledged. Only obligors with better than average ratings shall be acceptable for the purposes of the capital calculation and this must be demonstrated within the proposal or the background documentation. The credit institution may also rely on the borrower's credit risk ratings of its business partners, if existing and available, and if the credit institution can provide appropriate documentation to demonstrate their reliability and credibility.



76. When establishing the collateral value, the institution must take into account all factors that may weaken the enforcement of the collateral, including the costs of collection, the concentration risk within the portfolio of the credit institution and the concentrations within the receivables pools offered as collateral. Within its regulations the credit institution must address the method used to establish the collateral value of the receivables.
77. In order to assure the recovery of proceeds from a potential enforcement, the institution must have a documented procedure for the monitoring of the pledged receivables. The procedure must include the control of changes in the obligor's ability to pay. In addition, he must also monitor the legal factors (contractual obligations, legal provisions) that may affect the enforceability of the collateral.
78. The receivables pledged by a borrower shall be diversified and not unduly correlated with the borrower. Where there is material positive correlation, the attendant risks shall be taken into account in the setting of margins for the collateral pool as a whole.<sup>12</sup>
79. The credit institution must have a documented process for collecting receivable payments. The requisite facilities for collection must be in place even if collection is generally the responsibility of the borrower. The institution is expected to have procedures for debt management, identifying the person or organisation unit responsible for the collection of receivables, their responsibilities, assigning deadlines to the steps of collection, as well as the documentation required for the collection of receivables and collateral.
80. The value of the receivables is their outstanding amount. Internal regulations must provide for the methodology used for the calculation of the collateral value in the calculation of the capital requirement, with consideration also to the above requirements, as well as the way the value of the receivable is considered as a risk mitigation factor (such as the deduction of any receivables collected prior to the maturity date).
81. With regard to the reservations of the HFSA concerning the enforceability of receivables as collateral under the current economic and legal environment in Hungary due to their low levels of return, the HFSA expects institutions that consider receivables as credit protection, to examine the return ratios of loans secured by receivables in a documented way every year, and to make this documentation available to the HFSA if instructed to do so.
82. Also for the above reason, the HFSA will not recognise receivables as credit protection unless all of the above listed requirements are fully met, which the HFSA shall continuously examine.

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<sup>12</sup> A correlation may exist, for instance, if the obligor of the loan and the obligor of the receivables offered as collateral are active in the same industry. Concentration however, with regard to the obligor of the loan and the receivables offered as collateral, exists if for instance, the obligor of the loan has several receivables from the obligor of the receivables, and if he has offered only one of those to the creditor as collateral.



### 2.3.3 Overview of the Hungarian regulations related to receivables

83. Under current Hungarian regulations, provided that certain legal requisites are satisfied, receivables may be pledged as collateral under the following arrangements: attachment of an independent or contingent lien to the receivable, or assignment of the receivable. Paragraph (2) of Article 96 of the DCRR gives preference to the attachment of a lien to the receivables, the reasons of which will be discussed below.
84. A lien on receivables is recognised as collateral under the Hungarian legal system. Based on the lien, the beneficiary of the lien (the credit institution) may be satisfied from the pledged property ahead of other claims. The requirements of legal certainty and eligibility are met in the case of a lien on receivables if the lien has been registered in the registry of liens. Without this, the priority of the beneficiary of the lien can not be established in a credible way.
85. In terms of direct access, if the pledged receivable is aimed at the delivery of tangible property, it is also required for the rules of sale by the credit institution to be specified in the lien contract, including the minimum sales price, the mode of its calculation, as well as the deadline set by the credit institution for the sale, because otherwise the credit institution itself would not be eligible to sell the pledged property from the date of the devolution of the right of satisfaction.
86. Paragraph (2) of Article 267 of the Civil Code, which provides that the obligor of the claim must be notified in order for a lien to be enforceable, must be considered when calling the collateral.
87. The requirement of legal certainty may be affected by the provision contained in Paragraph (3) of Article 267 of the Civil Code stating that in case of a lien on a bank account balance prevailing on the basis of a bank account contract, the obligor of the lien may make effective legal statements, even without obtaining a statement of consent from the lien holder, that may terminate or adversely change the lien holder's basis of satisfaction. In such cases therefore, pursuant to the aforesaid code section, it is by all means necessary to include a specific clause in the lien contract that prohibits the removal (e.g., termination of the bank account) or adverse change (withdrawal of a significant amount) of the basis of satisfaction if the consent of the lien holder is not obtained.
88. When accepting collateral, institutions should consider Article 98 and Paragraph (3) of Article 108 of the Companies Act, pursuant to which a creditor of a member of a general partnership or a limited partnership may not use a tangible or intangible asset as security or for the purposes of satisfaction if that asset has been transferred by the member into the ownership of the company. Only those portions of equity are eligible as collateral for the claim of the creditor, which will be due to the member in case the partnership or his membership are terminated. On this basis, the members of such companies may create liens only on claims against the company that arise when their membership is terminated.
89. Under Hungarian law, it is possible to pledge a quota in a limited liability company, but neither the Companies Act nor the Corporate Proceedings and Final Settlements Act contain any provision that would require that a lien on a quota in a limited liability company be indicated (disclosed) anywhere. Therefore, a third party may already hold a lien on the quota, making the lien held by the institution enforceable only thereafter. In view of this, the pledging of a quota may not be used to reduce the capital requirement.
90. The current regulations on assignment do not satisfy the requirements of the CRD and the DCRR, therefore at present, on the basis of the argumentation presented below, a claim based on an assignment may not be recognised as an instrument of credit risk mitigation. The Civil Code fails to separately regulate assignment for the purpose of collateral,



it is therefore expedient to rely on the juridical practice for its assessment. Pursuant to Court Ruling No. 2001.489, if assignment is used as collateral, the right of the assignee to directly satisfy its claim on the assignor from the assigned claim, as contained in the contract for the assignment for collateral, terminates on the commencement of a liquidation procedure against the assignor. Therefore, if until the start of the liquidation, the creditor failed to collect from the obligor on the claim relying on the assignment, he can no longer dispose over it, because it becomes part of the estate of the debtor, and satisfaction may occur only in the strict order of priorities as defined in the Bankruptcy Act. If a liquidation procedure is initiated against the debtor, the assignment no longer represents adequate security for the creditor because it does not qualify as a privileged claim under the Bankruptcy Act.

91. The assigned claim is part of the estate of the debtor even if it is placed on a blocked account by the credit institution. Any amounts on a blocked account constitute part of the assets to be liquidated in the event of liquidation. In this event, the credit institution is not allowed to access the sum on the blocked account, because that would constitute the removal of the basis of satisfaction of other creditors.

## ***2.4 Eligibility and minimum requirements for mortgage on movable property***

### **2.4.1 Eligibility of mortgage on movable property**

92. Existence of a liquid market facilitating quick and economically efficient sales. The HFSA expects institutions to demonstrate that the market of any other tangible security offered as collateral is liquid and enables a timely sale.
93. Existence of a publicly quoted price. The institution must demonstrate that the net price received upon the sale of collateral is not materially different from this price. The requirement for a publicly quoted price may be met by movable property where public data sources or databases are available for the market price, such as a stock exchange quote, price quotes for motor vehicles (Eurotax database) or an official auction price (for art). Movable property must be sold at the market price, i.e., the price at which the asset could be sold at the time of its appraisal by a willing seller to a willing buyer in an arm's length transaction<sup>13</sup> (book value is not sufficient).

### **2.4.2 Minimum requirements for mortgage on movable property**

94. Legal security (see general requirements). Within this and in the context of the legal enforceability of collateral it should be noted, that only first liens or first security claims on the security can be enforced, with the sole exception of permitted priority claims on claims based on statutory regulations. Consequently, the credit institution must have priority over all other creditors in respect of the proceeds from the collateral.

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<sup>13</sup> CRD Annex VIII Part 3 Section 67, DCRR Article 147



95. Frequent monitoring and documentation of the value of the collateral at least once every year, or more frequent reviews if there are changes in the determinant market factors.
96. The HFSA expects the institution to declare what it considers as determinant market factors or changes that justify more frequent valuation. The CRD and the DCCR does not allow statistical valuation in case of movable property, therefore individual appraisals are required.
97. The loan agreement or security agreement must include a detailed description of the securities plus a detailed specification for the manner and frequency of revaluations. The agreement must provide for the frequency with which the institution may inspect the pledged property.
98. The types of physical collateral accepted by the credit institution, and policies and practices in respect of the appropriate value of each type of collateral relative to the exposure amount must be clearly documented in the regulations of the institution. The internal policies must specify the types of other real collateral accepted by the institution and the establishment of the collateral value of such other real collateral. The procedures must address the required collateral value of eligible other real collateral accepted for each exposure.
99. The institution's regulations for the assumption of risk must address the appropriate collateral requirements relative to the exposure amount, the enforceability of the collateral, the objective method for establishing its market value, the frequency with which the value can be readily obtained (including a professional appraisal or valuation), and the volatility of the value of the collateral.
100. Both the initial valuation and the revaluation must fully consider the impairment and obsolescence of the collateral.
101. The credit institution must have the right to physically inspect the collateral. The credit institution must have regulations and procedures addressing its exercise of the right to physical inspection. The institution must state its right to inspection in the contract. It must provide for the types of collateral and the conditions necessitating on-site inspection. It is reasonable to involve special expert(s) in case of special collateral, which should also be provided for.
102. The movable property used as collateral must be adequately insured against damages. The HFSA considers it expedient for the obligor of the lien to undertake in the lien contract to buy insurance cover and to designate the institution as the beneficiary of the insurance contract. The continuous existence of the insurance cover must also be monitored.

#### 2.4.3 Overview of the Hungarian regulations related to mortgage on movable property

103. Under current Hungarian regulations, movable property may be eligible as collateral under the following arrangements: **independent lien, possessory lien, mortgage or floating charge on assets.**
104. In case of a lien on movable property (assets), most conditions of applicability require, with the exception of possessory liens, the existence of some publicly credible register about the lien; of the aforementioned arrangements therefore, only those are acceptable that meet this condition.
105. In case of mortgage on movable property, pursuant to Paragraph (2) of Article 262 of the Civil Code, the contract must take the form of a notarized document and must be entered into the registry of liens. Considering that movable property is usually not registered, their exact definition tends to be impossible and therefore they can be defined only by description. Consequently, the registry of liens maintained by the Hungarian National Chamber



of Public Notaries (MOKK) records liens against the names of the owners. The requirement of legal certainty requires the institution to demand from the obligor of the physical lien to demonstrate, using a public deed requested from the registry of liens, that he is not listed in the registry. Furthermore, in case of movable property with some sort of registration (vehicles, pieces of art, etc.), and if such registry is used to register mortgages as an encumbrance, then the registry should be used as the primary source of proof for the absence of an encumbrance, to be expediently supplemented by a certificate as above, issued by the Hungarian National Chamber of Public Notaries (MOKK). The constitutive registration of encumbrances (with a mortgage) of registered movable property (airplanes and ships) is similar to that of real estate and therefore for such movable property it is primarily the registry that is considered authoritative.

106. In the event of the encumbrance with mortgage of machinery and equipment, it is possible to record the lien encumbrance in the records and the books of the lien obligor, in a manner that makes it accessible to third parties.
107. In case of a lien on movable property, a first lien must be established.
108. A possible problem, pursuant to Paragraph (6) of Article 262 of the Civil Code, could be the termination of a mortgage registered in the registry of liens, if the pledged property is sold in commercial circulation or in normal business activities to a bona fide buyer, because this may result in the elimination of the institution's basis of satisfaction.
109. The overlap of a mortgage on movable property and a floating charge on assets may also be problematic because, if the institution has mortgage over an object that is included in assets that have been pledged earlier, the institution may lose its basis of satisfaction if the holder of the floating charge on assets seeks satisfaction from the pledged assets though specification. This can be avoided if the institution ascertains that the movable property offered as collateral is not included in any assets previously pledged.
110. A floating charge on assets does not meet a substantial portion of the requirements imposed in statutory regulations. In case of floating charge on all of the assets, the movable property included within the assets is not clearly defined, therefore the liquid market enabling the timely sale of the collateral and the publicly quoted price cannot be established. In case of floating charge on assets, the 50% limitation on satisfaction continues to be in place under the Bankruptcy Act. Furthermore, the possibility of the timely sale is problematic, and the regular review of the collateral value is not possible. In case of a floating charge on assets, if all of the assets of the obligor are affected, the registry of liens contains only a reference to this effect. In case of a lien on a certain specific part of the assets (finished goods, inventories, materials), this specific group of assets should be accurately described in the document underlying the registration, or in its annex, and this is also how the registration should take place. Thus, in case of a lien for a certain specific group of the obligor's assets, it is possible to give an itemised list of movable property; therefore, if the institution has procedures for the regular monitoring of the existence of the assets (e.g., general ledger), then this may be considered in the same way as a mortgage on individual movable property items. However, due to the aforementioned provisions of the Bankruptcy Act, even in this case it will not be possible to recognise the full value of the collateral. This may be problematic for enterprises with high inventory turnover.
111. In case of warehouse warrants, the requirement of first lien is not applicable because, in accordance with Paragraph (5) of Article 20 of the Public Warehouses Act, the public warehouse is entitled to a lien over the goods as security for any public warehousing fees and other charges specified in the public warehouse contract, ahead of all other lien holders. Neither is this requirement met on the basis of Paragraph (5) of Article 38 of the Public Warehouses Act because in the event of the liquidation of the first endorser of the war-



rant, if the goods have not provided sufficient cover for the satisfaction of the holder of such warrant, the claim of the holder of the warrant has no priority for satisfaction and such claim must be ranked among other claims as defined under Section f) of Paragraph (1) of Article 38 of the Bankruptcy Act.

112. However, the Civil Code allows the warehouse warrant to be the subject of a security deposit, which has the benefit of affording direct satisfaction. It is important to highlight, however, that pursuant to Paragraph (2) of Article 338/A and Paragraph (1) of Article 270 of the Civil Code and Paragraph (5) of Article 26 of the Public Warehouses Act, the warehouse warrant as a security can fulfil its security deposit function only if the holder of the warehouse warrant is verified by the chain of endorsements and if the warrant is separate from the cedula, and contains the substantial requisites set forth in Paragraph (1) of Article 27 of the Public Warehouses Act. Furthermore, it must also be taken into account that, pursuant to Paragraph (3) of Article 27 of the Public Warehouses Act, warehouse warrants or any parts thereof may be used as security deposit only with a blank endorsement. Pursuant to Paragraph (1) of Article 32 of the Public Warehouses Act, if the amount indicated in the warrant is not paid to the warrant holder within three days of its maturity, he may demand that the goods in the public warehouse be sold and that he be satisfied from the proceeds. In case of a protracted sale the requirement of a timely sale may not be satisfied.

## ***2.5 Eligibility and minimum requirements related to financial lease***

### **2.5.1 Eligibility criteria**

113. Exposures arising from transactions where the credit institution provides a financial lease, can be treated as collateralised with a mortgage encumbered on the leased property, if it meets the minimum requirements for mortgage on real estate or movable property.

### **2.5.2 Minimum requirements for financial lease**

114. The conditions to be met are those listed under the minimum requirements for real estate or movable property depending on the type of property leased.

115. The following requirements must be met for real estate leasing: legal certainty, regular valuation of the property, credit policy concerning real estate leasing, insurance for the leased property.

116. The institution must have regulations and procedures concerning the use of the leased asset, for its age and expected useful life, as well as its value.

117. A robust legal framework must be in place ensuring the lessor's legal ownership of the asset and his ability to exercise his ownership rights, or his rights as a lien holder;

118. The difference between the original (non depreciated) value of the asset and its market value may not exceed its credit protection value, except if it has already been considered for the calculation of the LGD value.

### **2.5.3 Overview of Hungarian regulations related to leasing**

119. Lease contracts are atypical contracts not regulated in the Civil Code, therefore in the course of examining the requirements for leasing, the conditions of the transaction should serve as the primary starting point, which the parties are free to specify pursuant to Paragraph (1) of Article 200 of the Civil Code.



## ***2.6 Eligibility and minimum requirements for cash or deposits deposited with a credit institution not providing credit***

### **2.6.1 Eligibility criteria for cash or deposits deposited with a credit institution not providing credit**

120. The pledged asset should be deposited as a guarantee or deposit with the credit institution not providing credit.

### **2.6.2 Minimum requirements**

121. Requirement of legal certainty: the guarantee should be valid and enforceable under every jurisdiction.

122. The third party institution may make payments only if authorized by the lending credit institution. This requirement can be met, if the institution where the guarantee or the deposit is placed, is informed of the pledge of the pledged asset or of the purpose of the deposit.

123. The guarantee is unconditional and irrevocable. This requirement means that the contract establishing the collateral or the loan contract may not contain any provision that sets conditions for the guarantee or that authorises the guarantor to unilaterally recall the guarantee. Of course, this condition also governs the contract for the deposit.

124. In order for this type of collateral to be eligible, the contract must fulfil all of the above minimum requirements. There should be special emphasis on the obligation of the third party to co-operate.

### **2.6.3 Overview of Hungarian regulations**

125. Any cash or deposit placed at a third party may be used as collateral in the form of a guarantee or security deposit, because there are certain concerns related to assignment (see the section titled “Overview of the Hungarian regulations on receivables”).

## ***2.7 Eligibility and minimum requirements for life insurance policies or contracts used as collateral for default***

### **2.7.1 Eligible life insurance policies or contracts**

126. Life insurance policies or contracts can be recognised as collateral, if a lien has been established on the receivables arising from the policy or the contract to the benefit of the lending credit institution, and – with regard to the provisions of Paragraph (2) of Article 118 of the DCRR – if the lending credit institution is the beneficiary of such lien.



### 2.7.2 Minimum requirements for life insurance policies or contracts

127. The provider of the life insurance (insurer) may only be recognised, if it is a provider of unfunded credit protection subject to CDR Chapter VIII Part 1 paragraph 29.<sup>14</sup> Therefore, pursuant to this requirement, only life insurance provided by a provider of collateral recognised for unfunded credit protection can be accepted.
128. The receivables from the life insurance policy or contract must be encumbered with a lien to the benefit of the credit institution providing the loan. Therefore, naming the lending credit institution as the beneficiary is in itself not sufficient for the eligibility of this type of collateral.
129. The company providing the life insurance is notified of the pledge and as a result, the lending credit institution may seek satisfaction from the pledged property ahead of all other claims. For this condition to be fulfilled, the institution must ascertain – in addition to informing the insurer – that the policy or contract is not encumbered by any other lien, which assumes the cooperation of the insurer and the lending credit institution, and also assumes that insurers have procedures suitable for the identification of liens on policies and contracts.
130. The insured amount or the surrender value of the policy or contract may not decrease.
131. The lending credit institution must be entitled to receive a portion of the surrender value of the policy or contract, as specified in the lien contract, if the client is in default.
132. The lending credit institution shall be informed of any non-payments under the policy or contract by the policy-holder or contracting party. The obligation to inform the creditor must be either part of the life insurance contract or the issue must be settled in the agreement between the creditor and the insurance provider. The institution must develop a procedure, on the one part for how such notifications should be handled, and on the other part for the procedure to be followed in such cases.
133. The life insurance must serve as collateral for the entire term of the loan. Where the insurance relationship ends before the maturity of the loan, a specific portion of the insured amount or the surrender value as specified in the lien contract and pursuant to the insurance policy or contract, must serve as security until the maturity date of the loan. Thus the insurance must be matched to the term of the loan, or else the contract for the security must provide for this situation.
134. Requirement of legal certainty.

### 2.7.3 Overview of the Hungarian regulations on life insurance policies

135. One of the minimum requirements (although this is rather a condition of eligibility) for life insurance policies or contracts is for the lending credit institution to be its beneficiary. The designation of the beneficiary and its including in the life insurance contract should be ef-

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<sup>14</sup> DCRR Article 109



fective furthermore, in case of an insurance event as a condition precedent, the credit institution should have a right (that may not be restricted) to demand an appropriate portion of the insurance amount. Pursuant to Paragraph (2) of Article 560 of the Civil Code, the contracting party is entitled to designate a beneficiary or to designate a replacement for the original beneficiary however, if the contracting party is a person other than the insured person, the written consent of the insured person is also required. In the latter case, the absence of the consent of the insured party renders the designation of the beneficiary null and void pursuant to Paragraph (2) of Article 561 of the Civil Code. The contracting party can freely dispose of the insurance amount in excess of the outstanding debt, and, unless another beneficiary is designated, he (or his heir) is entitled to such remaining amount pursuant to Paragraph (2) of Article 560 of the Civil Code.

136. The insurance amount and the surrender value specified in the life insurance contract cannot be reduced. With regard to the insurance amount this should be provided for within the lien contract, while a reduction of the surrender value is prohibited under Paragraph (1) of Article 565 of the Civil Code, pursuant to which the insurance provider is obliged to repay a part of the premiums paid as specified in the regulations (surrender amount).

## ***2.8 Eligibility and minimum requirements for securities secured with repurchase guarantees***

### **2.8.1 Eligibility requirement**

137. These should be securities issued by a third party credit institution that will repurchase them on request.

### **2.8.2 Minimum requirements**

138. The CRD (DCRR) does not specify any relevant minimum requirements.

## ***2.9 Requirements for collateral when using an own-LGD estimate with consideration to collateral***

139. The requirements for own-LGD estimates are specified under CRD Annex VII Part 4 Section 2.2.2 (DCRR Articles 74-76), with provisions also for the collateral considered for the LGD estimate as follows:

140. A credit institution shall consider the extent of any dependence between the risk of the obligor with that of the collateral or collateral provider. Cases where there is a significant degree of dependence shall be addressed strictly (in a conservative manner).

141. Currency mismatches between the underlying obligation and the collateral shall also be treated conservatively in the credit institution's assessment of LGD.

142. To the extent that LGD estimates take into account the existence of collateral, these estimates shall not solely be based on the collateral's estimated market value. LGD estimates shall take into account the effect of the potential inability of credit institutions to expeditiously gain control of their collateral and liquidate it.

143. To the extent that LGD estimates take into account the existence of collateral, credit institutions must establish internal requirements for collateral management, legal certainty and risk management that are generally consistent with those set out in the CRD Annex VIII Part 2 (DCRR Chapter XV).



## 3 UNFUNDED CREDIT PROTECTION

### *General Requirements*

144. The credit protection must be provided by a reliable party<sup>15</sup>. The reliability of the provider of the credit protection means that in the case of a default by the borrower, the provider of the protection for the contract can meet, in a timely fashion, its payment obligation on the basis of its secondary obligation. To that end, the institution must specify, within the framework allowed under the statutory regulations, who it will recognise as protection providers, and what requirements it will set for such protection providers, and it must also examine whether the protection provider has already undertaken commitments earlier in respect of other obligations.

145. The requirement for legal certainty also applies here, i.e., the agreement for the credit protection must be valid and enforceable in front of the competent judicial authority<sup>16</sup>.

### *3.1 Eligibility and minimum requirements concerning unfunded credit protection*

#### **3.1.1 Eligible protection providers**

146. The following parties may be recognised as eligible providers of unfunded credit protection under all approaches:

- Central governments and central banks;
- Regional governments or local authorities;
- Multilateral development banks;
- International organisations, exposures to which a 0 % risk weight under CRD Articles 78 to 83<sup>17</sup> is assigned;
- Public sector entities, exposures to which should be risk weighted as exposures to institutions (credit institutions and investment firms) or which can be risk weighted using identical risk weighting as for the central government<sup>18</sup>, institutions (credit institution and investment firm);
- Other corporate entities, including parent, subsidiary and affiliate corporate entities of the credit institution pursuant to the Act on Accounting, that:
  - Have a credit rating from a recognised external credit assessment institution (ECAI) of credit quality rating 2 or above; or
  - Have no credit rating from a recognised ECAI, but use the IRB approach and assign a PD to their exposure that meets at least credit quality rating 2 as rated by the recognised ECAI.

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<sup>15</sup> ACI Article 76/E Paragraph (7)

<sup>16</sup> ACI Article 76/E Paragraph (7)

<sup>17</sup> DCRR Article 8

<sup>18</sup> CRD Articles 78-83, DCRR Article 6 Paragraphs (2) and (3)



- Pursuant to the discretion allowed under the CRD, Member States may also recognise as eligible providers of unfunded credit protection, other financial institutions authorised and supervised by the competent authorities responsible for the authorisation and supervision of credit institutions, if they are subject to prudential regulations equivalent to those applied to credit institutions. The Hungarian legislator has used this discretion to qualify as recognised providers of unfunded credit protection the financial firms that meet the prudential regulations equivalent to those applied to credit institutions.

147. Pursuant to Article 87/A of the ACI a financial enterprise is subject to prudential requirements equivalent to those applied to credit institutions if it satisfies the provisions on solvency margin, capital adequacy, restriction of risks and investments, and the rating of assets applicable to credit institutions, and if it has an equity of at least two billion Hungarian Forints. It is up to the HFSA to consider whether a particular financial enterprise qualifies as one subject to prudential requirements equivalent to those applied to credit institutions, and to issue a resolution to this effect. On its homepage the HFSA publishes the list of financial enterprises recognised as such. It should be noted here, that as of today the HFSA has recognised only Hitelgarancia Zrt as a recognised financial enterprise.

148. If the credit institution uses an internal rating based approach to calculate the value of the risk weighted exposure and the value of the expected loss, the provider of the collateral can be recognised only if it is rated internally by the credit institution in line with the provisions of CRD Annex VII Part 4<sup>19</sup>, except if statutory regulations allow an exemption.

#### **Other providers of collateral recognised if the procedure contained in Annex VII Part 1 Section 4 (DCRR Article 30 Paragraph (3)) is used**

The provisions of the referenced Section and Article essentially allow credit institutions using an internal ratings based approach to recognise the correlation between the probability of default of the obligor and the provider of the collateral in the course of the calculation of the capital requirement when considering the risk mitigating effects of unfunded credit protection provided by the organisations listed below (including insurers and re-insurers). By using a more risk-sensitive, internal ratings based approach for the capital requirement, the calculation of the capital requirement performed using the substitution approach is corrected using the correlation that considers the case of so called dual default, which considers that the obligation will only represent a loss for the credit institution if the obligor and the provider of the collateral default at the same time.

149. Recognised providers of collateral include credit institutions, financial firms subject to prudential regulations equivalent to those of credit institutions, investment firms, insurers, re-insurers and export credit agencies, that:

- Have been in the business of providing unfunded credit protection for at least one year;

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<sup>19</sup> DCRR Chapter XIII



- Are rated by a recognised ECAI with a credit rating of at least 3;
- Have had an internal rating when providing the credit protection or thereafter, to which, under the standardised approach, the lending credit institution has assigned a PD corresponding to a credit rating of at least 2 on the basis of the rules for the risk weighting of exposures to the enterprise;
- Has an internal rating, to which, under the standardised approach, the lending credit institution has assigned a PD corresponding to a credit rating of at least 3 on the basis of the rules for the risk weighting of exposures to the enterprise;

150. Credit protection provided by export credit agencies may not be guaranteed by the central government.

### 3.1.2 Minimum requirements concerning unfunded credit protection

151. The credit protection must be direct. The requirement of directness means that upon default by the client, the creditor may directly address the provider of the collateral for payment.

152. The extent of the credit protection must be clearly defined and incontrovertible (clearly defined). This requirement means that the guarantee obligation of the protection provider must be clearly defined. The contract must clearly define the content of the obligation of the protection provider.

153. The contract for the credit protection may not contain any clause, the fulfilment of which is outside the direct control of the lender, and which:

- Would allow the protection provider to unilaterally cancel the protection;
- Would increase the effective cost of protection as a result of deteriorating credit quality of the protected exposure;
- Could prevent the protection provider from being obliged to make a contractual payment in the event that the original obligor fails to make a payment that is due. In our position this stresses the timely performance of the contract, in order to meet the requirement, the contract must determine when the beneficiary becomes entitled to satisfaction, how many notices must be sent to the original obligor and within how many days and under what conditions the protection provider must perform. The contract may not contain any provision that, under certain circumstances, discharges the collateral provider from the obligation to perform on time. If the unfunded credit protection provides additional collateral for a mortgage on a residential real estate property, the collateral must be realised within two years from the default, i.e., the payment on the basis of the collateral must be made within a maximum of two years.
- Could allow the maturity of the credit protection to be reduced by the protection provider, that is, the contract must provide a precise definition for the duration of the guarantee obligation of the protection provider.

154. Requirement of legal certainty

155. The credit institution must demonstrate to the supervisory authority that it has procedures and processes in place to manage potential risk arising from the credit institution's use of guarantees and credit derivatives. This requirement means that the credit institution must be able to demonstrate how its strategy in respect of its use of credit derivatives and guarantees integrates into its overall risk management system. Such a potential risk could include the concentration of risks, which the credit institution should be able to monitor and which it should manage. Guarantors must be rated and exposures must be monitored on an aggregate basis (direct and indirect exposures), and the internal policies of the institution must describe the procedures relevant for the various specific levels of concentration.



**Other minimum requirements specified under CRD Annex VIII Part 2 Sections 18 and 19 (DCRR Article 123) for guarantees and suretyship**

156. On the qualifying default of and/or non-payment by the counterparty, the lending credit institution shall have the right to pursue, in a timely manner, the guarantor for any monies due under the claim in respect of which the protection is provided. If the unfunded credit protection provides additional collateral for a mortgage on a residential real estate property, it is sufficient to fulfil this requirement also within a period of two years.
157. Enforcement of the guarantee shall not be subject to the lending credit institution first having to pursue the obligor. On this basis so called sequential guarantees are excluded.
158. The guarantee and the suretyship shall be an explicitly documented obligation assumed by the guarantor;
159. The guarantee shall cover all types of payments the obligor is expected to make in respect of the claim of the credit institution. Where certain types of payment are excluded from the guarantee, the recognised value of the guarantee shall be adjusted to reflect the limited coverage.

**Additional minimum requirements applicable if the procedure under Annex VII Part 1 Section 4 (DCRR Article 30 Paragraph (3)) is used**

160. The underlying obligation must exist towards the following organisations:
- To an enterprise, not including insurers or re-insurers;
  - To a regional government or local government or a public sector institution to which the risk weighting applied to the central government and the central bank can not be applied;
  - To micro-, small or medium enterprises falling within the residential exposure class.
161. The obligors of the underlying transaction may not belong to the same client group as the provider of the collateral.
162. The exposure must be covered using the following instruments:
- A credit derivative on a single underlying reference instrument and a guarantee or suretyship for a single exposure;
  - A basket product that can be called at the first default, defined by the lowest risk weighted exposure value instrument within the basket; or
  - A basket product that can be called at the  $n^{\text{th}}$  default, defined by the lowest risk weighted exposure value instrument within the basket, with the proviso, that the protection obtained will only qualify as credit protection if it also extends to the collateral for the  $(n-1)^{\text{st}}$  default, or if the  $(n-1)^{\text{st}}$  claim within the basket is already in default;
163. The credit protection complies with the provisions under DCRR Articles 120, 121, 123 and 125.
164. Credit risk mitigation is not present in the risk weight assigned to the exposure before the procedure specified under Article 30 Paragraph (3);
165. The credit institution receives payment directly from the provider of the credit protection, without enforcing a claim against the obligor of the underlying exposure;
166. The credit protection covers losses generated on the covered part of all risks arising as a consequence of a credit event;
167. The sequence of satisfaction for the assigned obligation arising from the loan, bond or additional payables conforms to the sequence specified by the competent legal authority;



168. The conditions of the credit protection have been specified by the provider of the credit protection and the credit institution;
169. The credit institution has procedures to identify any correlation between the provider of the credit protection and the obligor of the underlying exposure; and
170. In the case of credit protection for dilution risk, the seller of the purchased receivable may not belong to the same client group as the provider of the credit protection.

### 3.1.3 Minimum requirements for guarantees when considering the risk mitigating effects of guarantees in the LGD estimate, if own-LGD estimates are used<sup>20</sup>

171. The below requirements are to be applied to exposures to companies, institutions (credit institutions and investment firms), central governments and central banks, where the credit institution prepares its own LGD estimates, i.e., for portfolios covered by the AIRB approach and for retail exposures.
172. If the credit institution using the AIRB approach can use the standardised approach for exposures to the central government, central bank, credit institutions and investment firms, then the below listed provisions are not applicable to the guarantees provided by those. In this case the credit institution may recognise unfunded credit protection pursuant to Articles 76/E-76/F of the ACI .
173. In case of guarantees for retail exposures these requirements are to be used when assigning exposures to categories and pools, as well as when estimating the PD value.
174. Credit institutions must have clearly defined criteria when calculating risk weighted exposure values for types of recognised guarantors. This requirement therefore prescribes that the internal regulations of the institution must specify who it recognises as providers of unfunded credit protection.
175. In the case of recognised guarantors the same rules are to be applied as specified for clients within CRD Annex VII Part 4 Sections (17)-(29)<sup>21</sup>. Examples for these include the categorization and rating of collateral providers, conditions for changes in ratings, specification of who may conduct reviews and how often, putting the contract in writing, excluding the right of the guarantor to terminate, etc.
176. The written contract for collateral must be effective until the guarantor has completely fulfilled its obligations (with regard to the amount and the term of the guarantee and the suretyship). Namely, the guarantor may not be discharged of his obligation of guarantee until he has fulfilled his payment obligation arising due to the default or the non-contractual performance of the original obligor. This requirement does not mean to exclude a mismatch between the maturities of the obligations of the original obligor and the guarantor, which is allowed when using the IRB approach, but that the guarantor may not be dis-

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<sup>20</sup> CRD Annex VII Part 4 Sections 96-100 and DCRR Article 80 Paragraphs (1)-(7)

<sup>21</sup> DCRR Articles 58-62



charged of his payment obligation under the contract for the collateral.<sup>22</sup> The right of the guarantor or of the surety to terminate must be excluded and the collateral must be legally enforceable against the guarantor or the surety within the jurisdiction, where the guarantor or the surety has assets that can be seized and for which a judgement can be enforced.

177.The recognition of conditional guarantees is subject to approval by the HFSA. This requires that the credit institution demonstrate that it can quantify and effectively and continuously monitor the risk mitigating effects of the conditional guarantee.

178.The credit institution must demonstrate, that the assignment criteria for grades or pools can appropriately handle any potential deterioration of the risk mitigation effect.

### **Adjustment criteria**

179.Credit institution must have clearly specified criteria for adjusting grades, pools or LGD estimates, and, in the case of retail and eligible purchased receivables, the process of allocating exposures to grades or pools, to reflect the impact of guarantees for the calculation of risk weighted exposure amounts. These criteria must comply with the minimum requirements set out in CRD Annex VII Part 4 Paragraphs (17)-(29)<sup>23</sup>.

180.The criteria must be plausible and intuitive. They must address the guarantor's or the surety's ability and willingness to perform under the guarantee, the timing of any payments from the guarantor or the surety, the degree to which the guarantor's ability to perform under the guarantee is correlated with the obligor's ability to repay, and the extent to which residual risk to the obligor remains.

#### **3.1.4 Minimum requirements for counter-guarantees**

181.Where an exposure is protected by a guarantee which is counter-guaranteed by a central government or central bank, by a regional government or local authority having the same risk weight as its central government, by a public sector entity having the same risk weight as a credit institution, investment firm or central government, or by a multilateral development bank with a risk weight of zero, the credit institution may treat the exposure as if it was directly covered by a guarantee provided by the said institution, provided that the following conditions are satisfied:

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<sup>22</sup> An example for this would be if the payment obligation of the primary obligor would exist for 1 year with quarterly instalments but the guarantor would undertake a guarantee not for the entire duration of the payment obligation of the primary obligor, i.e., for 1 year, but for three quarters of a year (representing a mismatch of maturities). If the obligor would fail to pay the second instalment, the guarantor would become obliged to make payment, of which he may not be relieved even if the "term" of the guarantee, i.e., the 3<sup>rd</sup> quarter would have passed. Thus, the guarantor would only be discharged of the obligation if the primary obligor would have fully met his payment obligation that was guaranteed by the guarantor.

<sup>23</sup> DCCR Articles 58-62



- The counter-guarantee covers all credit risk elements of the claim.
- Both the original guarantee and the counter-guarantee meet the requirements set for guarantees and suretyship<sup>24</sup>, with the exception of the direct nature of the counter-guarantee. The conditions specified under Article 123 Paragraph (1) Sections a) and b) (ability to claim within a reasonable time, direct nature) are met by guarantees and counter-guarantees provided by these organisation, if:
  - The lending credit institution is entitled to a preliminary payment by the guarantor, the extent of which is calculated by estimating the amount of the economic loss in proportion to the extent of the collateral provided by the guarantee and likely to be suffered by the lending credit institution, including losses from no payment of interest and other payments to be performed by the borrower;
  - The lending credit institution can demonstrate that this procedure is justified by the effects of the guarantee in covering losses, including losses from the non payment of borrower's payment obligations.
- The collateral is reliable and historical data do not indicate the value of the counter-guarantee collateral to be lower than the direct guarantee provided by the said institution. This must be demonstrated by the institution on the basis of its past experience.

Therefore, in the interpretation of this provision, if an exposure is provided with a counter-guarantee by an institution listed here and if it can be considered by the credit institution as covered by a direct guarantee undertaken by the provider of the counter-guarantee, then the provider of the “guarantee/suretyship” may also be an organisation otherwise not acceptable as a provider of a guarantee or suretyship, because instead of his guarantee the guarantee of the counter-guarantor can be considered and the guarantee need not satisfy the provisions of DCRR Article 108 for accepted guarantors.

182. It is also possible to consider a counter guarantee as above, if it is provided by a counter-guarantor not listed above, if this counter-guarantee is secured by the guarantee or suretyship of the above organisations.

### 3.1.5 Over view of the Hungarian regulations concerning unfunded credit protection

183. Hungarian legislation lists guarantees and suretyship as unfunded credit protection<sup>25</sup>. Thus, in the Hungarian legal system the general concept of “guarantee” does not exist, and the provisions specified by the CRD and the DCRR for guarantees are realised mostly by bank guarantees. It is the position of the HFSA, that all instruments for the mitigation of credit risk that fulfil the concept of unfunded credit protection and satisfy the eligibility and minimum requirements for guarantees, may be considered according to the rules specified for the treatment of guarantees, and can be recognized for the calculation of the capital requirement.

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<sup>24</sup> DCRR Articles 120, 121, 123

<sup>25</sup> DCRR Article 96 Paragraph (3)



In this regard there is no difference with regard to whether the institution accepting the insurance or guarantee uses a standardised approach or an internal ratings based approach for the calculation of the capital requirement for credit risk, because unfunded credit protection can be recognised under both approaches, only they are considered in different ways.

184. There are several views that have evolved concerning the eligibility of **bank guarantees** as instruments for the mitigation of credit risk. According to some, bank guarantees are not eligible because under the CRD/DCRR a guarantee requires unconditional commitment where the institution may call down the collateral without any conditions, without the need to present additional documents, in other words, the institution is not under any obligation to prove that the guarantee can be called. The other view holds, however, that bank guarantees are eligible if the ability to call the guarantee is made subject to the occurrence of some event, such as the default of the borrower. This requirement is satisfied if the guarantee contract provides that the guarantor undertakes an unconditional and irrevocable obligation to make a payment upon the first notice of the creditor, without regard to the underlying legal relationship, despite any legal objection or dispute raised by the Bank or any other third party, to the benefit of the creditor, to the maximum amount indicated in the guarantee agreement. Furthermore, it is also necessary for the notice to be issued to the guarantor to contain a statement by the creditor that the borrower has not satisfied its contractual payment obligations.
185. As regards the requirement of legal certainty, no letter of intent issued by a prospective guarantor should be regarded as a bank guarantee, and the existence of a letter of intent should not be used as a basis for risk mitigation. It may occur that the bank issues a letter of intent to undertake a guarantee for the debt of the borrower, and the parties make the conclusion of the contract subject to the existence of such letter of intent. The judicial practice does not consider such letters of intent to constitute a bank guarantee and thus the guarantor may not be obliged to make any payment on that basis.
186. According to the CRD/DCRR, the guarantor may not unilaterally cancel the contract for a reason, the observance of which falls outside the control of the lending credit institution. In respect of the bank guarantee, the Civil Code does not provide specifically for cancellation, therefore the parties may agree on this issue at their discretion. However, the contract may not contain any clause that would be contrary to this.
187. In case of a bank guarantee, the guarantor must make payments to the institution up to a specified amount, which is completely independent of the size of the debt of the borrower. Thus, the guarantee covers all types of payment obligations relating to the claim only if a sufficiently high amount was set as the limit in the guarantee contract. Consequently, the satisfaction of the criterion can be assessed only on a case-by-case basis.
188. Accordingly, the eligibility of bank guarantees depends on the wording of the contract and the terms of the transaction.
189. With regard to the criterion of legal certainty, in the case of suretyship it is necessary to look at the cases where the surety may be exempted from the liability.
190. According to Paragraph (1) of Article 273 of the Civil Code, the surety may effect the same objections that can be enforced by the obligor against the beneficiary. Such objections may include, for instance, the fact that the claim is not due or that the beneficiary is in default. According to the commentary to the Civil Code, the surety may enforce objections owing to the obligor as well as objections owing to itself vis-à-vis the beneficiary even if they arose from a different legal relationship. On this basis therefore, the surety may be exempted from performance (however, the surety may not effect any objection based on a



legal relationship with the obligor vis-à-vis the beneficiary). Therefore the surety may be exempted from performance. This rule however, is based on the Civil Code and due to its permissive nature, it may be excluded by the parties in the contract.

191. Pursuant to Paragraph (2) of Article 273 of the Civil Code, the obligation of the surety may not subsequently exceed the original obligation. This may be the case where the borrower and the creditor amend the contract by extending the performance deadline. In this case the consent of the surety must also be acquired, because, in the absence of such consent, the creditor may not enforce any interest due for the extended payment term.
192. Pursuant to Paragraph (2) of Article 276 of the civil code, a surety shall be released if the creditor waives a right securing the claim, on the basis of which the surety could have received satisfaction of the claim devolving on him, or if the claim has become irrecoverable for reasons attributable to the beneficiary. On this basis therefore, the creditor also has obligations towards the surety, and failure to abide by these may result in the release of the surety. This obligation includes, on the one hand, the obligation that the creditor must maintain the collateral existing at the time of the inception of the suretyship (for instance, it may not waive any rights to mortgage created before the suretyship was undertaken and, equally, the mortgage must be registered in the property register), and also that he must take measures to collect the claim so that the right of the surety to satisfaction in the event of the insolvency of the borrower is not forfeited.
193. The surety is also released if a debt is assumed without obtaining the consent of the surety. Pursuant to Section Paragraph (3) of Article 332 of the Civil Code, the suretyship and liens securing a claim shall cease to exist upon the assumption of debt in the absence of statements of approval from the surety and the obligor of the lien.
194. The same situation may result if the obligation is transferred to another person by virtue of law, because, pursuant to Article 333 of the Civil Code, if an obligation passes to another person by virtue of a legal provision or official order, unless otherwise provided therein, the provisions governing the assumption of debt shall be duly applied. One typical example may be inheritance. For instance, if the debtor dies, his place is taken by his heir by virtue of general legal succession (the obligation passes by virtue of a legal regulation), whereas the surety may successfully claim that he has not consented to maintain his suretyship if the person of the debtor changes, albeit through inheritance.
195. The recognition of direct suretyship depends on the consideration of the above criteria, while simple, deficiency suretyship can under no circumstances be eligible under the CRD/DCRR because the simple surety may file an interpleader, that is, he may demand that the beneficiary first attempt to recover the claim from the obligor.
196. As to legal certainty, the following should be noted in respect of sovereign suretyship: pursuant to Government Decree 110/2006 (May 5) on the procedures for preparations for sovereign suretyship and the enforcement of suretyship, when cashing individual suretyships, individual state guarantees, state counter-guarantees and legal suretyships listed in the Decree (under Paragraph (1), Article 9), the state tax administration shall proceed as prescribed under Act XCII of 2003 on the Rules of Taxation, whereby for the latter two cases the Decree itself also stresses that applications will be rejected by the tax administration if the procedure of the credit institution in the course of lending does not comply with the provisions of the separate Act or of the Decree. Pursuant to the above Act on the rules of taxation and under Article 117 with provisions on the audits related to the cashing of state guarantees (suretyship), in the course of deciding on a request for cashing a state guarantee the tax administration examines whether the legally required conditions for cashing a guarantee (suretyship) are met, and may also extend this examination to the original obligor. If the procedure followed by the credit institution does not meet the conditions,



the tax administration will reject the request for the cashing of the state guarantee (suretyship). This may happen if the credit extended with sovereign surety is used for a purpose different from the one specified in separate statutory regulations and if the credit institution fails to satisfy its obligation pursuant to Paragraph (4) of Article 78 of the ACI, to monitor and document the existence of the contractual conditions throughout the term of the contract containing the commitment. There are occurrences in banking practice where a credit institution concludes a security deposit agreement with the obligor in respect of a part of the credit to be extended with sovereign surety, i.e., it withholds the amount of the security deposit from the credit amount to be disbursed. This may become problematic if the tax administration refuses to cash the sovereign suretyship in respect of the amount of the security deposit, because the amount of the disbursed credit corresponding to the security deposit was not used for the specified credit purpose, therefore that part of the credit is not covered by the sovereign surety. In this case therefore, the credit institution may not consider the entire credit to be covered by sovereign suretyship. The cashing of sovereign suretyship may also be rejected if the credit institution, in view of the security provided by the state suretyship, concludes the credit contract without the appropriate caution or without the usual professional due diligence, in violation of the provisions of Paragraph (1) of Article 78 of the ACI (for instance, failing to verify whether the subject of the mortgage to secure the credit transaction is indeed owned by the debtor at the time when the credit agreement is concluded), and due to this the state as surety is unable to enforce its right to recourse.<sup>26</sup> The security provided by sovereign suretyship may not be used by the credit institution as grounds to be less circumspect in its lending activities. Accordingly, credit institutions must proceed with exceptional care and diligence when lending with sovereign surety, because in the absence of due care and diligence the lender may lose the ability to enforce the collateral. Within this circle it is also of great significance to accurately observe the rules of the Decree with regard to cashing in order to avoid the frustration of cashing due to formal reasons (such as pursuant to Paragraph (3) of Article 9 of the Decree, if the contract for credit affected by sovereign surety is terminated, or if the obligor has not yet fully repaid the loan at final maturity, then the credit institution may enforce its rights from sovereign suretyship vis-à-vis the tax administration of the state as of the 31<sup>st</sup> day following the date of termination. Cashing takes place using a requisition form submitted to the tax administration, etc.).

197. As another problem related to sovereign suretyship, pursuant to Paragraph (4) of Article 33 of the Public Finances Act, the state as a general rule undertakes simple suretyship only, and a Government resolution may only deviate from this if the case is justified. In the case of simple suretyship, the surety is obliged to pay only if the claim cannot be collected from the original obligor or from sureties that undertook that obligation at an earlier date without consideration to such state surety. This has an effect on the requirement that payment by the guarantor may not be subject to a provision that requires the lending credit institution to first have to pursue the client. The obligation of the simple surety is secondary, and

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<sup>26</sup> Tax and Audit Bulletin 2005/9



he may raise a so-called interpleader as long as the claim can be expected to be recovered. Thus, based on the CRD/DCRR, simple sovereign surety can not be accepted for the reduction of the capital requirement. The direct suretyship of the state is based on statutory regulations and government resolutions and it is therefore very rare for sovereign suretyship to be recognisable as a factor for credit mitigation. In such cases, it is necessary to also examine the individual statutory regulations and government resolutions to establish what terms they have set in respect of the suretyship that may affect the ability to recognise sovereign surety.

198. Further to all of the above, pursuant to Paragraph (4) of Article 3 of Decree 48/2002 issued by the Minister of Finance on the detailed rules for the assumption and enforcement of counter-guarantees by the national budget, the extent of the sovereign counter-guarantee is limited inasmuch, that it may not exceed 70% of the amount paid by the surety. According to the business regulations of HG Zrt, the suretyship undertaken by the firm does not exceed the amount of the suretyship fee, any supplementary (default) interests charged for the default of the obligor and any bank guarantee fees charged by the credit institution. As the extent of the counter-guarantee is limited in its alignment with the guarantee provided by HG Zrt, its recognised value therefore, if it is accepted, should also be adjusted in line with the limited collateral.
199. Local governments may also undertake direct surety, the upper limit of which however, pursuant to Paragraph (2) of Article 88 of Act LXV of 1990 on Local Governments, is the amount of their adjusted own revenues, and thus their suretyship can only be accepted as collateral with consideration to this upper limit.



## 4 INTERNAL GOVERNANCE, INTERNAL CONTROL

### 4.1 *Internal governance*

#### 4.1.1 Examination of internal governance in the course of validation

200. The CRD and the Hungarian regulations also prescribe requirements concerning the corporate governance and internal governance systems of credit institutions. Furthermore, the GL 10 specifies the considerations enforced by the HFSA in the course of validation with regard to the internal governance system of a credit institution. Further to these, the HFSA also reviews compliance with the content of the recommendation of the Board of the HFSA<sup>27</sup> as general requirements.

201. The CRD<sup>28</sup> imposes general and comprehensive requirements concerning the corporate governance of institutions: every credit institution must have a reliable governance system, including the following:

- Transparent organisation structure;
- Clearly delineated, transparent and consistent responsibilities;
- Effective procedures for the identification, management, monitoring and reporting of current or potential risks related to exposures;
- Appropriate internal control mechanisms, including reliable administrative and accounting procedures.

202. With regard to their corporate, competency and organisational aspects, the aforesaid requirements are already included in the legislations (corporation law) of the Member States.

203. The recommendations set out in the GL 10 provide the considerations for examinations and thus can not in themselves be enforced, but should be used as the starting point by the HFSA to develop its expectations for internal governance to be used as a condition for the authorization of the use of advanced approaches. **The HFSA makes validation conditional on substantive requirements.** This means that the HFSA sees a risk if the control functions set out in the guidelines are satisfied in a formally defined corporate system, but if the system of control responsibilities and powers is not adapted to the characteristics of the group, its business rationale, that is, the system is unable to fulfil its substantive function or can do so only with undue administrative burdens and costs. The GL 10 internal governance recommendation is targeted, i.e., the internal governance requirements applied by supervisors must promote the security of the use of the advanced approaches, and their application must use a case-by-case approach, tailored to the institution.

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<sup>27</sup> Recommendation No. 11/2006 on the Establishment and Operation of Internal Lines of Protection

<sup>28</sup> CRD Article 22, ACI Article 13/C Paragraph (1)



204. For validation the HFSA requires the demonstration of the allocation (by authority and responsibility) of the functions set out in this chapter within the credit institution and the group and their linkages. In the course of validation, the HFSA considers the nature of the operations of the applying credit institution, its size and complexity, and where justified accepts the arrangements chosen by the institution<sup>29</sup>. Uniform treatment is implemented by the HFSA by requiring all institutions to account for the same internal governance functions and action mechanisms, but also employing the principle of proportionality.
205. The requirement of adequate institutional corporate governance set out in the CRD is broader than the requirements concerning internal governance applied in the course of validation. For instance, the relevant authority demands adequate corporate governance when licensing entry in the market of the Member State or, in case of incumbent institutions, in the course of ongoing supervision. In the course of validation, the HFSA examines the internal governance related aspects of corporate governance, but the assessment focuses on the internal governance mechanisms necessary for the application of the advanced approaches.
206. The expectations related to internal governance are more or less the same as the expectations that a prudent owner and investor would otherwise reasonably expect from the credit institution. However, advanced approaches introduce a number of business innovations (e.g., models) into the business process, and their proper use and the control of processes requires more advanced internal institutional relations and governance systems.
207. Models prepared exclusively to reduce capital requirements cannot be permitted for use. In order to prevent this, there is a requirement that systems and processes used to the calculation of the capital requirement should play a fundamental role in risk management and decision making processes<sup>30</sup>. Thus, the purpose of supervisory validation is to ascertain the existence of internal governance not only on paper (see also the Use test chapter).
208. Before permitting the use of advanced approaches, the HFSA examines whether the management of the institution (owner or body representing the owner and the management) is mechanistically capable of performing its internal governance functions and whether it actually performs them with due diligence and care. In the case of non-resident institutions this often necessitates contacting the home supervisory authority, because that is the authority that has an overview of group-level governance, and the description of the subsidiary systems in itself does not facilitate the assessment of the governance of the entire group.

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<sup>29</sup> CRD Article 22; ACI Article 13/C

<sup>30</sup> CRD Article 84, Paragraph 2 (b); ACI Article 76/B Paragraph (2) / CRD Annex IX Part 3 Section 2; Government Decree on Operational Risk Article 7 Paragraph (2) / Directive 2006/49/EC Annex V Paragraph 2 a); Government Decree on Trading Books Article 43 Paragraph (4) a) / CRD Annex III Part 6 Sections 28-30; Government Decree on Counterparty Risk Article 22



209. With regard to credit risk, internal regulations for rating and estimation procedures must be approved by the Board of Directors of the credit institution.<sup>31</sup> The governing body must have a general understanding of the essential characteristics of the institution's systems related to advanced approaches as well as of the related management information systems.<sup>32</sup> Also for other risks it is justified for the internal regulations on advanced approaches to be approved by the Board of Directors and for them to have a general understanding of the essential characteristics of the systems.
210. Given the diversity of corporate forms and corporate bodies it is difficult to prescribe in formal terms which bodies should be entitled or obliged to approve which issues. In the course of validation, the HFSA focuses on the substance of the requirement, i.e., that the internal governance function is performed as expected. It is not the names of the organisation units that carry significance, but rather that in the course of performing their two fundamental functions (supervision and management), the delegated powers of the various bodies should be in line with their responsibilities. Thus the purpose of supervisory validation is to ascertain that both the body representing the owner and senior management take on the appropriate responsibilities.
211. For instance, senior management has the clear responsibility to notify the Board of Directors without request and without delay of any actual or imminent changes in the operation of the systems of the credit institution or in any factors affecting those.<sup>33</sup>
212. Senior management must have a good understanding of the structures and operations of the rating systems and must ensure their proper operation on an ongoing basis, including any adjustments that may become necessary.<sup>34</sup> They must provide regular information about the risk control activities of the credit institution, the areas needing improvement and the effectiveness of efforts to eliminate previously identified deficiencies.
213. The HFSA places special emphasis on verifying that the senior bodies of a subsidiary have a good understanding of any decisions taken in the head office concerning the implementation of advanced approaches, about the proposed approaches and their application.

#### 4.1.2 Examination of international groups

214. In its capacity as the home authority, the HFSA has the obligation and the power to monitor and enforce the adequacy of the internal governance system. If, however, the competent authority of another Member State is responsible on the group-level and within the group because the Hungarian subsidiary also submits and application to introduce the approach used by the group, then the HFSA, pursuant to Article 129 of the CRD<sup>35</sup>, will re-

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<sup>31</sup> CRD Annex VII Part 4 Article 124; DCRR Article 93 Paragraph (1)

<sup>32</sup> CRD Annex VII Part 4 Article 124;

<sup>33</sup> CRD Annex VII Part 4 Article 125; DCRR Article 93 Paragraph (2); Government Decree on Counterparty Risk Article 20 Paragraph (3)

<sup>34</sup> CRD Annex VII Part 4 Article 126; DCRR Article 93 Paragraph (3)

<sup>35</sup> ACI Articles 14/A-14/B



quest the competent authority to examine and demonstrate whether a reliable governance system is in place on the group level (as set forth in the CRD and the CEBS Guidelines). This, however, does not render the assessment of the internal governance system of the subsidiary unnecessary to demonstrate appropriate operation as part of the group. This “double assurance” must be provided irrespective of the significance of the subsidiary because the ongoing monitoring of the smallest subsidiary is the responsibility of the HFSA.

215.If an advanced approach is used, the institution must satisfy the requirements of a reliable internal governance system irrespective of the location of its head office. In case of a group headed by a Hungarian institution this means that the HFSA provides home supervisors with the proposed criteria for the assessment of internal governance.

216.Before they adopt a resolution, the relevant authorities will consult one another if their resolutions are relevant for the supervisory functions of the other relevant authorities.

#### 4.1.3 Tailored application, principle of proportionality

217.In the course of validation, the HFSA uses a tailored approach to its own general validation requirements, that is, it assesses the organisation structure of the institution, its size, complexity and the nature of its business activities and examines whether the required supervisory content in respect of internal governance is satisfied in the specific form.<sup>36</sup> For the organisational structure of the institution and its bodies this means the following:

218.The GL10 recommendation for internal governance does not wish to override the existing governance frameworks (bodies and organisation) within the institutions. The HFSA strives to assure that the internal governance function expected under the recommendation is present in the corporate governance framework concerned and that the powers, responsibilities and reporting systems operate adequately.

219.The Directive appreciates the differences that exist between the member states of the European Union due to legal and regulatory reasons, concerning both the names and structures of management bodies and their functions, with respect to which the Directive sets out the corporate governance (and not internal governance) requirements. Accordingly, supervisory validation imposes requirements on the allocation of functions and operating procedures of such bodies, irrespective of their legal forms but with consideration to statutory provisions.

#### 4.1.4 Functions of the internal governance system

220.Whether a unitary or dual system, the corporate structure of the institution must fulfil two basic functions: supervision and management. In relation to the internal governance system the wording of the CRD and GL 10 uses “*management body*” to mean the top management body performing supervision and management functions (e.g., supervisory board, board of directors), while “*senior management*” means the body subordinated to the management body and performing day-to-day executive management functions.

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<sup>36</sup> CRD Article 22; ACI Article 13/C Paragraph (1)



221. In the course of validation, the HFSA examines whether the *responsibility* of the supervision or management function is delegated to the appropriate hierarchical level and whether they are accompanied by sufficient *powers*.

222. *Responsibility* means whether someone can be held responsible for the success of a process, while *power* means whether someone can make a decision and hold someone else responsible for the success of a process. While these terms can be understood in legal terms, *accountability* means that the aforesaid system of responsibilities and powers is viable and operational in practice, safeguarded by the organisation, decision making and procedural systems. Thus responsibility, power and accountability are characteristics of the operations of the various bodies, levels, positions and employee groups.

223. The key to an adequate internal governance system is a transparent and balanced system of responsibilities and powers. This applies equally to both decision making and supervision processes.

224. A „management body” is responsible for the following:

- Elaboration of the institution’s policies, setting its directions, monitoring of the achievement of the corporate strategy;
- Approval of all material aspects of the adequate risk control system.

225. Senior management assures the operation of all system elements as expected as well as the control of the system.

226. Internal audit assures the regular evaluation of the internal control systems, including the objectivity and completeness of the control function.

227. The adequate operation of the risk control system is the responsibility of the management body. The entire management body (both in its supervisory and management functions) is responsible for the approval of all material aspects of the risk control function, including:

- Risk management strategies and policies regarding the internal rating system (including all material aspects of the rating scale and the process for the estimation of risk parameters, etc.);
- The organisational structure of the control functions;
- Specifying the acceptable types of risk, specification of the risk ‘appetite’;
- Developing the risk profile of the institution.

228. The management body should verify on an ongoing basis that the control procedures and measurement systems adopted by the risk control and internal audit functions are adequate and that the overall system remains effective over time and, where necessary, is modified.

229. The management body (both in its supervision and management functions) is responsible for decisions to use an advanced approach. This includes the overall approval of the project(s), the specification of the objectives and the designation of the organisation structure responsible for the implementation. The time scheduling of the necessary steps (implementation plan) must be an integral part of project approval. The management body (in both its supervisory and management functions) has final responsibility for the operation of the appropriate system.

230. The management body in its management function ensures that each component of the system (including its audits) operate as originally planned. The management body in its management function must be able to continuously demonstrate that the control and measurement systems used by risk control are adequate and that the system in general remains effective over time.



231. The tasks allocated to this management body should include the following:

- Ensuring the soundness of risk-taking processes, even in a changing environment;
- Determining the function of the advanced approach in the risk-taking process;
- Informing the management body (in its supervisory function) or a designated committee of material changes or exceptions from established policies that will materially impact the institution's systems;
- Identifying and assessing the risk drivers;
- Defining the tasks of the risk control units and evaluating the adequacy of their professional skills;
- Monitoring and managing all sources of potential conflicts of interest,
- Establishing effective communications channels in order to ensure that all staff are aware of relevant policies and procedures,
- Defining the minimum content of reporting to the management body (in its supervision function) or to an appropriate representative body of delegated members (e.g., the risk committee);
- Utilising reports from internal audit.

## 4.2 *Internal control*

### 4.2.1 **The internal reporting system**

232. The reports supplied to the body in management function must be suitable to be used for the monitoring of risks. The level of detail of the information supplied in the internal reporting system depends on the nature, size and complexity of the business activities of the institution.

233. It is not only management bodies that should be informed about the risk profile of the institution. All staff undertaking or monitoring risks must be informed using the internal reporting system. The frequency and content of such information and reporting must be approved by the management bodies (both in the supervision and management functions).

234. The CRD, DCRR and GL 10 contain the minimum requirements for **credit risk** reporting.<sup>37</sup> In addition to meeting the minimum requirements, best practice should also include the following:

- A description and characterisation of the rated portfolio (amounts, number of obligors, PDs by grade, percentage of coverage by rating grade for the entire portfolio, in breakdown by organisation units, sectors, sub-portfolios and business units);

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<sup>37</sup> CRD Annex VII Part 4 Article 127; DCRR Article 93 Paragraph (4)



- The distribution of the overall portfolio according to rating grades, PD bands, and LGD grades, and comparisons to the prior year;
  - A comparison of realised default rates to expected default rates, losses at default and credit conversion factors calculated earlier;
  - The results of stress tests;
  - Estimates for the regulatory capital requirements and for economic capital;
  - The portfolio's migration across rating grades.
235. The frequency of reporting should be set according to the significance and type of the information and on the nature of the recipient as regards powers and responsibilities. For instance, the representative of the owners, who determines the risk appetite as part of the credit institution's strategy, monitors actual risk taking in a different context and with different frequency than a top manager responsible for the consistency of risk taking and management.
236. In addition to the aforementioned reports, credit risk control should prepare special reports on the overview and assessment of the rating system for the management body fulfilling the management function. The credit risk control unit is responsible for providing coherent, intelligible and usable reporting to users, tightly and clearly related to target variables.
237. With regard to operational risks it is also an expectation to develop an internal reporting system.<sup>38</sup> Based on statutory provisions the institution must prepare regular reports at least once every year for the Board of Directors and for senior management on exposures from operational risk and losses from operational risk. For institutions performing large-scale complex activities it is justified however, to prepare reports at least quarterly.
238. With regard to market risks it is also an implicit expectation to provide information to management with the appropriate frequency and the appropriate level of detail. Statutory regulations specify in detail the (minimum) contents of the reports to be provided to management when using internal models.<sup>39</sup> In addition to this, the institution must establish clear reporting pathways for the unit responsible for the process of valuation, independent of the business areas, which should end with an executive member of the Board of Directors.<sup>40</sup>
239. Since credit institutions must have reliable, effective and overall strategies and procedures in order to specify and continuously maintain the right amount and the right composition of capital required as collateral for their actual and future risks<sup>41</sup>, it is therefore practicable for internal reports to also contain information on all relevant risks not mentioned before. The risks that are identified and their management should be presented in the manage-

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<sup>38</sup> CRD Annex X Part 3 Paragraph 4; Government Decree on Operational Risk Article 7 Paragraph (3) a)

<sup>39</sup> Government Decree on Trading Books Article 43 Paragraphs (4) a) - c)

<sup>40</sup> Government Decree on Trading Books Annex 13 Paragraph 1 b)

<sup>41</sup> CRD Article 123; ACI Article 76/K



ment information system in proportion to the nature, the magnitude and the complexity of the institution's activities.

### 4.3 *Risk control*

240. It is an expectation of institutions using advanced approaches to create independent risk control units / functions for the various types of risks. In addition to the credit risk control unit – the requirements for which will be detailed as follows – the following controls should also be established (among others):

- Operational risk<sup>42</sup>
- Trading book risk<sup>43</sup>
- Counterparty risk<sup>44</sup>

#### 4.3.1 **The credit risk control function**<sup>45</sup>

241. The GL 10 places special emphasis on the requirement for the existence of a Credit Risk Control Unit, while it repeatedly emphasises that it is the independence of the function, rather than the organisation unit, that is important. In certain circumstances (e.g., small banks with non-complex operations) the credit risk control function may be performed by another organisation unit rather than an organisation specifically set up for this purpose, while the independence of the function must be ensured. According to the Directive, it is necessary to differentiate between organisational and functional requirements for credit risk control. In the course of validation, the continuous and adequate performance of the independent control function must be demonstrated to the HFSA rather than the existence of an organisation unit with a name indicated in the recommendation. The monitoring and control of lending is also an organic part of the consistent process of risk management (identification, measurement or assessment, mitigation, management, monitoring, control). Credit risk control is a dual task: it is included in both management and supervisory responsibilities, naturally with different substance in accordance with the levels of the responsibilities.

242. In case of large, sophisticated institutions with complex, innovative, cross-border operations, the examination of organisational and governance requirements is a much more complex task for the HFSA than in the case of smaller, local institutions. Such credit institutions are required to establish risk control units. A large banking group with complex operations in several countries may satisfy this requirement in a number of ways.

243. The credit risk control unit/function has complex responsibilities, including<sup>46</sup>:

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<sup>42</sup> CRD Annex X Part 3 Paragraph 3; Government Decree on Operational Risk Article 7 Paragraph (2)

<sup>43</sup> Government Decree on Trading Books Article 43 Paragraph (4) b)

<sup>44</sup> Government Decree on Counterparty Risk Article 19 Paragraph (1)

<sup>45</sup> CRD Annex VII Part 4 Articles 128-130; DCRR Article 94



- Testing and monitoring of grades and pools;
- Production and analysis of summary reports about the credit institution's rating systems;
- Enforcement of procedures and verification that grade and pool definitions are consistently applied across departments and geographic areas;
- Reviewing and documenting any changes to the rating process, including the reasons for the changes;
- Reviewing the rating criteria to evaluate if they remain predictive of risk. (Changes to the rating systems, criteria or individual rating parameters must be documented and retained.)
- Active participation in the design or selection, implementation and validation of models used in the rating process.
- Oversight and supervision of models used in the rating process;
- Ongoing review and alterations, if necessary, to models used in the rating process.

244. Credit risk control must provide for the maintenance of the rating system with the appropriate frequency. To this end, credit risk control must perform the following tasks:

- Design of the rating system;
- Ongoing review of the rating criteria and model development;
- Monitoring and verification of the accuracy of all risk-rating grades;
- Assessment of consistency across industries, portfolios and geographic areas (regions);
- Assessment of the use of the model in business practice;
- Analysis of the reasons for overrides and exceptions to model ratings;
- Design of quantifications and algorithms;
- Back testing;
- Analysis of actual and predicted rating migration (borderline cases);
- Benchmarking against third-party data sources.

245. The credit risk control unit/function must prepare regular reports and analyses on the results of the rating systems.<sup>47</sup>

246. In the course of validation, employing the principle of proportionality, the HFSA does not necessarily require that a separate organisational unit be created and, as a matter of fact it may even question whether it is reasonable to create an independent organisation. In par-

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<sup>46</sup> CRD Annex VII Part 4 Paragraph 129, DCRR Article 94 Paragraph (3)

<sup>47</sup> CRD Annex VII Part 4 Paragraph 128, DCRR Article 94 Paragraph (2)



ticular, it may be unreasonable for small institutions with less complex operations to set up such a separate organisation.

247. Depending on the size and complexity of operations of the institutions using the advanced approaches, the HFSA will accept a range of organisational structures provided that the organisational arrangement does not endanger the fundamental principle of the independence of credit risk control, the requirement of objectivity and the general suitability of the control environment.

248. Objectivity may be compromised for a number of reasons: such as if the model builder is biased towards the model outcomes, or may tolerate potential errors or distortions. It is the task of internal control to identify risks in the particular organisation due to conflicts of interest or lack of objectivity. Internal control must at the same time also ensure transparency in all cases if the two tasks are performed within the same organisation.

249. Thus the HFSA does not intend to specify where the credit risk control function should be located within the organisation structure, because the right place of the credit risk control function, which encompasses a significant part of the institution's operations, must be specified by the institution in line with its own organisation structure and operations and fully observing the requirements presented in this chapter.

250. It is a supervisory requirement, however, that the credit risk control function, irrespective of its place within the organisation, should report directly to the management body with management functions. On the other hand, it is the responsibility of internal audit to examine whether the position of the credit risk control function is appropriate and whether its independence is not compromised due to its position.

251. The credit risk function should always have a high standing within the organisation and should have sufficient resources available. It must be staffed by individuals possessing the requisite qualifications, experience and abilities.

252. The credit risk control function must be ensured to have independence from the functions responsible for the approval or renewal of exposures.<sup>48</sup> The function responsible for the approval and renewal of exposures is the business area and the risk managers participating in the decisions for the individual transactions.

253. Lack of independence of the credit risk control function and pressures from relationship managers directly involved in lending could seriously undermine the effectiveness and soundness of internal rating systems. While communication between the areas is part of day-to-day operations, a solution must be found to enforce and to ensure independence.

254. A control function is independent if the following conditions are met:

- The staff of the control function shall not be required to perform any tasks that they otherwise monitor and control in their control function;

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<sup>48</sup> CRD Annex VII Part 4 Paragraph 128, DCRR Article 94 Paragraph (1)



- The control function should be organisationally separate from the activities it is assigned to monitor and control;
- The head of the control function should be subordinated to a person who has no responsibility for managing activities that are being monitored and controlled.
- The head of the control function should report directly to the management body (in both supervisory and management functions) and/or to the Audit Committee;
- The remuneration of the control function staff may not be dependant on the success of the activities that the control function is assigned to monitor and control.

255. There is no single best way to achieve independence, but rather there are different options. One option is to make the credit risk control unit depend directly on the management body, another option could be to maintain a separation between the control function and the business function by designating a person from the management body to be responsible for the function.

256. Whichever option is adopted by the institution, part of the duties of internal audit should be to determine the real degree of independence of the operation of the credit risk control function.

257. Irrespective of the separation of organisation units, the responsibility for model design and implementation, including the design of models or the choice between available models, their application, implementation, monitoring and the effectiveness of operation, the identification of necessary corrections - should rest with the person responsible for credit risk control. The two functions of model development and control may be performed in the same organisation unit. This organisationally 'permissive' approach is reasonable because skills, expertise and experience (necessary for model development or selection from existing models) are scarce, so that there are only one or two persons capable of reviewing and validating the models.<sup>49</sup>

258. The assignment of the two model-related functions to the same organisation unit should not result in a conflict of interest or in any other loss or disadvantage.

#### 4.3.2 Internal audit

259. It is expected of independent internal audit to regularly validate (at least once every year) compliance with the requirements of the CRD. Consequently, internal audit should report at least once every year to the management body (in both its supervisory and management functions) on compliance with the requirements.

260. Implicitly, the application package must also contain a report on the audit by the internal auditor and the action plan prepared for the elimination of the deficiencies found.

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<sup>49</sup> It is also very expensive to create two separate units for the two functions, especially for smaller institutions, and furthermore, two separate organisation units will not exclude conflicts of interest, which however will not necessarily exist if the two functions are performed within a single organisation unit.



261. The internal audit function assures that the institution's control systems are sufficiently robust and stable<sup>50</sup>. In the course of the review of control mechanisms, internal audit should assess the depth, coverage and quality of the operation of the credit risk control function. Internal audit also conduct tests to confirm that conclusions of the credit risk control function are well-founded. Internal audit should also review the adequacy of the IT infrastructure and data maintenance. For institutions using statistical models, internal audit should conduct tests (for example, on specific business lines) in order to also audit the data input process.
262. In order to strengthen its independence, Internal Audit should not be directly involved in model design or selection.
263. Notwithstanding the need for independence, some cooperation between Internal Audit and the credit risk control function can be desirable, for example in order for internal audit to point out certain weaknesses or biases existing in the system. It should be clear that the credit risk control function has sole responsibility for the performance of the systems. The audit function should not be involved in day-to-day operations such as reviewing individual rating assignments.

#### 4.4 *Other*

##### 4.4.1 **Further issues related to independence and conflicts of interest**

264. The CRD includes numerous references concerning the need for certain overview tasks to be performed by independent assessment organisation units. For example, there must be an ongoing overview of the process of operational risk management and the measurement system, which may be performed by either an internal or external auditor. The unit performing the assessment reports directly to management. It is the responsibility of the institution's management to ensure that reporting is independent, whether assigned to an internal unit or to an external auditor.
265. An institution using a purchased system is not discharged of the responsibilities related to rating approaches. It is an emphasised expectation in relation to a purchased methodology for management to meet the expectation of general understanding and good understanding and for the institution to have an organisation unit or function that can assess the suitability of the purchased system with regard to substance. An independent review must also cover purchased systems.

##### 4.4.2 **Outsourcing**

266. Credit institutions using pooled data may outsource the following tasks<sup>51</sup>:
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<sup>50</sup> CRD Annex VII Part 4 Paragraph 131; DCRR Article 95 / CRD Annex X Part 3 Article 6; Government Decree on Operational Risk Article 7 Paragraph (5) / Government Decree on Trading Books Article 43 Paragraph (11) / Government Decree on Counterparty Risk Article 21 Paragraph (1)

<sup>51</sup> CRD Annex VII Part 4 Article 130; DCRR Article 94 Paragraph (4)



- Production of information relevant to the testing and review of grades and pools;
- Production and analysis of summary reports on the credit institution's rating systems;
- Production of information about the review of the rating criteria to evaluate if they remain predictive of risk;
- Documentation of changes to the rating process, criteria or individual rating parameters;
- Production of information concerning the ongoing review and alterations of models used in the rating process.

267. It is the duty and responsibility of credit institutions that use outsourcing to ensure access for the competent authorities to all relevant information from the third party that is necessary for examining compliance with the minimum requirements and to ensure that the competent authorities may perform on-site examinations to the same extent as they would within the credit institution.

268. In case of intra-group outsourcing, the competent authorities agree on the levels of compliance with the minimum criteria and on which competent authority should verify compliance in its own right or outside the responsibility of the national legal authority on the basis of an assignment.

269. The internal audit must review, at least once every year, the rating systems of the institution and their operation, including the operation of the lending function as well as the estimation of PD, LGD and EL values and of credit conversion factors. The review must also extend to compliance with the applicable minimum requirements. In case of subsidiary credit institutions, this review function of internal audit may not be outsourced even to the group level.

#### 4.5 ***Verification of compliance with the requirements of a reliable governance system***

270. The HFSA examines compliance with internal governance requirements on the basis of documents submitted by the banks and information obtained in interviews. The documents must contain a description of the processes, authorities and division of responsibilities, and the linkages between those, used by the institution to meet the requirements set out in this chapter. The document to be submitted should not present an organisation chart or a job description, but a flowchart and the "network of responsibilities". In case of subsidiaries, a brief description by the supervisory authority of the parent institution is needed to describe the typical features of group governance that affect the subsidiary.

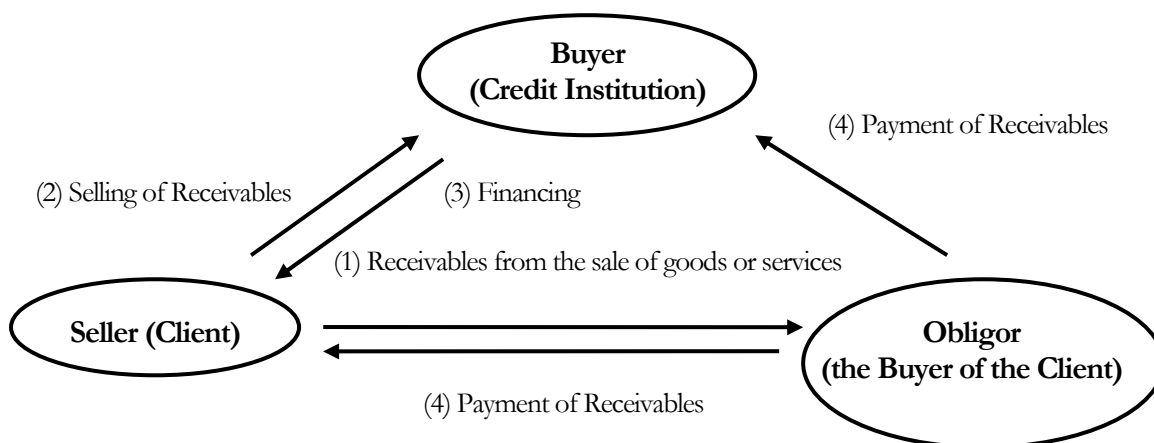
## 5 PURCHASED RECEIVABLES

### 5.1 Introduction

271. The CRD provides no clear definition for purchased receivables. The HFSA uses an approach that relies on the characteristics of the transaction and sets out its economic substance.

272. Purchased receivables cannot be classified into an independent exposure class; instead, they represent a form of cross-financing between asset classes, typically used in relation to commercial transactions, the sale of goods and services. The rules for purchased receivables are identical to those applicable to factoring or invoice discounting (forfeiting), or asset-backed transactions – excluding the cases where work-out receivables are sold.<sup>52</sup>

273. Purchased receivables may be classified into corporate or retail exposures. A triangular relationship is created between the participants of the transaction, as follows:



274. The ACI<sup>53</sup> classifies the purchasing, advancing and discounting of receivables as money lending, with a reference that factoring and forfeiting are also to be included in this interpretation. The HFSA therefore interprets the purchasing of receivables as the transfer of receivables in return for a consideration, corresponding to assignment pursuant to the Civil Code<sup>54</sup>, where any owned or purchased receivables may be subject to sale and purchase.

275. The ACI provides the following definition for purchased receivables: all receivables not yet due, or overdue by not more than 90 days, created with the assignment of a purchase

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<sup>52</sup> Transactions where a loan provided to the company is sold and shown in the books of the purchasing party.

<sup>53</sup> Annex No. 2 Part I Subsection 10.2. b)

<sup>54</sup> Articles 328-331 of Act IV of 1959



of a product or service in a business transaction, or with the assignment of an asset backed transaction.<sup>55</sup>

## 5.2 *Definition of purchased receivables in relation to the rules on capital requirements*

276.If the credit institution purchasing the receivables has full recourse to the seller of the purchased receivables (in a transaction with the right to recourse), the exposure should be treated as a claim covered by the assignment of receivables<sup>56</sup>. This chapter of these Guidelines will therefore only discuss transactions without the right to recourse.

277.Regulatory requirements for this type of financing must on the one side be aimed at ensuring that the dilution risk that usually arises is appropriately accounted for, and on the other side that the use of corporate risk measurement methods would represent an unjustified burden for the institutions.

## 5.3 *Conditions for assignment into the retail exposure class*

278.The minimum requirements for the internal ratings based (IRB) approach impose various rules for internal rating systems for both corporate and retail exposures. While the rating of corporate exposures relies on detailed information, the rating of retail exposures relies mainly on statistical data. If the standards for corporate exposures were applied to eligible purchased corporate receivables, this would impose a very strict requirement on the institution in cases when the obligor is not its client and when the information necessary for corporate rating is not available. In such cases, purchased receivable of the corporate business line are to be rated using the minimum requirements of the IRB with regard to the retail business line, in accordance with the rules of the IRB approach for purchased receivables.

279.For purchased receivables of an enterprise that fulfils certain criteria<sup>57</sup>, the rules for the quantification of retail exposure risks may be used if the use of the rules for corporate exposure risks would pose an unjustified burden for the institution<sup>58</sup>. For purchased receivables of an enterprise that has been classified as a retail exposure it is the obligation of the institution to demonstrate that the enterprise fulfils the criteria specified in the statutory regulations.

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<sup>55</sup> ACI Annex III/A Section 22

<sup>56</sup> From an economic viewpoint transactions with full recourse are to be considered as transactions collateralised with receivables. CRD Article 87 Paragraph (2)

<sup>57</sup> CRD Annex VII Part 1 Section 14, DCRR Article 27 Paragraph (3)

<sup>58</sup> CRD Annex VII Part 1 Section 7, DCRR Article 30 Paragraph (8)



280. The satisfaction of the criteria depends on the following factors<sup>59</sup>:

It should meet the minimum requirements for purchased receivables<sup>60</sup>;

The institution should have purchased the receivable from an unrelated third party (the seller and the buying institution should be independent of each other). Pursuant to this requirement, neither of the parties should be in a position to influence the internal decision-making processes of the other. The requirement of independence between the seller and the institution purchasing the receivables is intended to prevent credit institutions from bypassing the minimum capital requirements of the advanced IRB approach for corporate exposures by selling receivables for which they have no internal rating systems. Receivables purchased by an institution may not, either directly or indirectly, originate from the institution itself.

The claim of the seller is a claim created between independent parties;<sup>61</sup>

There is no tight relationship between the seller and the obligor, i.e., there is no material contagion risk between them: in other words, claims or contra-accounts between affiliated companies are not eligible;

The claim of the institution is on all of the revenues from the purchased receivables or on a proportional part thereof;

The portfolio must be sufficiently diversified. One way to implement this requirement could be for the institution to set the concentration limit<sup>62</sup> in the form of an absolute limit by defining an absolute amount for the maximum exposure for each counterparty, or as a relative limit by specifying the maximum exposure per counterparty as a percentage of the entire pool.

281. If a corporate purchased receivable does not meet all of the aforesaid essential conditions, it will be subject to the general IRB minimum requirements for **corporate exposures**.

282. A situation is to be considered as 'unduly burdensome' if all of the following conditions are fulfilled<sup>63</sup>:

There are too many obligors that the institution is unable to rate using its normal rating system

The institution has insufficient information about such firms because they are not its direct clients and the information necessary for their individual rating is not available.

A maximum exposure size could be a complementary requirement.

283. When institutions can collect sufficient data on individual obligors, they should abandon the top-down approach for purchased corporate receivables (where the measurement of

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<sup>59</sup> CRD Annex VII Part 1 Section 14; DCRR Article 27 Paragraph (3)

<sup>60</sup> CRD Annex VII Part 4 Sections 105-109, DCRR Articles 83-87

<sup>61</sup> Arm's length relationship, i.e., there is a certain "distance" between the obligor and the seller of the receivables.

<sup>62</sup> It is difficult to specify concentration limits, but for instance it is unacceptable if more than half of a portfolio is against the same enterprise.

<sup>63</sup> Annex VII Part 1 Section 7; DCRR Article 30 Paragraph (9)



risk is only possible on a statistical basis, because the bank does not know the individual obligors) and use the bottom-up approach instead (if the institution is not unduly burdened by identifying the risks related to the individual obligors).

#### 5.4 *Minimum requirements for purchased receivables (operational requirements)*<sup>64</sup>

##### 5.4.1 **Legal enforceability**

284. The contract must ensure that under all foreseeable circumstances the institution should have effective ownership of all rights related to the purchased receivables and control of all cash flows originating from the receivables. Where the obligor makes payments directly to a seller or a third party managing the receivables on a daily basis (portfolio manager), the institution must verify that payments are made in full compliance with the terms of the contract.

285. Institutions must have procedures to ensure that the institution can enforce its rights to the receivables without delay in the event of bankruptcy or other legal disputes.

##### 5.4.2 **Effectiveness of the monitoring system**

286. The institution must monitor both the quality of the purchased receivables and the financial condition of the seller and the portfolio manager, as well as the procedures used for rating them.

287. The institution must assess the relationship between the quality of the purchased receivables and the financial situation of both the seller and the portfolio manager. It must have internal regulations that provide adequate safeguards to protect against unforeseen events and to ensure the credit quality of the receivables and regular performance.

288. The credit institution must have clear and effective regulations to specify the eligibility of the seller and the portfolio manager. The institution or its agent must periodically review the eligibility of such parties in order to verify the accuracy of their reports, to detect fraud or operational weaknesses, to verify the quality of the seller's lending regulations and the regulations and procedures of the portfolio manager with regard to the collection of claims. The findings of these reviews must be documented.

289. The institution must assess the characteristics of the pools of purchased receivables: excessive advances, the credit history of the seller, non performing loans, events related to non performing loans, payment discipline, payment terms and any contra-accounts (offsetting).

290. The credit institution must have effective regulations for monitoring single-obligor concentrations on an aggregate basis, both within and across pools of purchased receivables.

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<sup>64</sup> CRD Annex VII Part 4 Sections 105-109; DCRR Articles 83-87



291. The institution must make sure to receive reports from the portfolio manager, with adequate frequency and detail, on the maturities (lapses) of receivables and their dilution, to ensure that they meet the institution's eligibility criteria and advancing policies and to ensure that it serves as an adequate tool to control and approve the sales policies and dilution risk management practices of the seller.

#### **5.4.3 Effectiveness of the work-out system**

292. The institution must have systems and procedures suitable for the early detection of any deterioration in the seller's financial situation and the quality of the purchased receivables and to prevent any problems that may arise. The institution must have clear and effective regulations and suitable information systems to detect contract violations, to initiate legal action and to manage problematic claims.

#### **5.4.4 Effectiveness of control systems for collateral, credit drawdown and collection**

293. The institution must have clear and effective procedures and regulations for the regulation of the purchased receivables, the loan and collection. There should be regulations to specify all material elements affecting the receivables purchase programme, including the advancing rates, the range of eligible collateral, the range of necessary documentation, concentration limits and the management of cash accounts. These elements must consider all relevant and material factors, including the financial situation of the seller/portfolio manager, the risk concentrations, changes in the quality of the purchased receivables and in the client base of the seller, the clientele of the seller and the internal systems that ensure that payment is only possible against the specified collateral and documentation.

#### **5.4.5 Compliance with the credit institution's internal policies and regulations**

294. The institution must have an effective internal control process to ensure compliance with all internal regulations. The process must include regular audits of all critical points of the institution's receivables purchasing programme and audits of the separation of duties on the following levels: between the assessment of the seller and the portfolio manager and the assessment of the obligor, between the assessment of the seller and the portfolio manager and the on-site audit of the seller and the portfolio manager. In addition to this, the operation of the back office must also be assessed, with particular concern for the qualifications and the professional experience of the staff working there, sufficiency portfolio staffing levels and systems to facilitate automation.



## 5.5 *Dilution risk*

295. Dilution risk<sup>65</sup> is the risk that the recoverable amount may be reduced through credits to the obligor. The risk originates from the rights of the obligor of the purchased receivables to reduce the amount to be received by the original beneficiary of the receivables, including obligor's rights to guarantees from the original beneficiary for deficient performance, and the rights of the obligor to offset the amount of any overdue claims from the original beneficiary against the actual amount owed.

296. It is up to the institution to specify which events it considers as dilution risk events. In cases where the institution is in doubt as to whether or not a particular event should be treated as a dilution risk, it should treat it as a dilution risk.

297. Because of the dilution risk, the treatment of purchased receivables under the IRB approach is different from the treatment of other retail/corporate exposures, but the dilution risk must be taken into account irrespective of whether the top-down or the bottom-up approach is used.

298. Dilution risk should be weighted using a special risk weight,<sup>66</sup> except for the case when the institution can demonstrate that the dilution risk is immaterial and need not be identified.

299. Materiality in this respect should be assessed at the pool level. The materiality threshold for the expected loss should be specified by the institution. This threshold should be conservative, as dilution risk is a true risk indicator for this type of financing and institutions should be able to manage this risk.

300. In respect of dilution risk, credit institutions need to estimate only expected loss (EL), which is to be broken down into PD and LGD only if the credit institution can do this in a reliable manner (with sufficient justification)<sup>67</sup>.

301. EL for dilution risk can be estimated in various ways<sup>68</sup>. For purchased receivables recorded among retail exposures, the following are the rules for the estimation of PD and LGD and for the calculation of the maturity (M), with regard to both credit risk and dilution risk<sup>69</sup>:

### **PD:**

- a) If the credit institution is unable to reliably estimate PD:
  - For senior exposures:  $PD = EL / LGD$

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<sup>65</sup> CRD Article 4 Section 24; ACI Annex III/A Section 4

<sup>66</sup> CRD Annex VII Part 1 Section 28; DCRR Article 38

<sup>67</sup> Annex VII Part 1 Section 35. Pursuant to DCRR Article 39 Paragraph (5) the expected loss calculated for purchased receivables for dilution risk can be calculated using the following formula:  $EL = PD \times LGD$

<sup>68</sup> Annex VII Part 2 Articles 5 and 7, DCRR Article 44 Sections 5 and 7-11

<sup>69</sup> Provisions for purchased receivables and dilution risks: CRD Annex VII Part 1 Sections 7 and 14; CRD Annex VII Part 2 Sections 8/g and 13/d; CRD Annex VII Part 3 Section 6; CRD Annex VII Part 1 Section 28, Annex VII Part 2 Sections 8, 18, 19, 20; CRD Annex VII Part 4 Sections 16, 53, 60, 61, 69, 84, 100, 102; DCRR Article 7 Paragraph (3), 30 (8), 45, 46, 47 (6), 48, 49, 51 (6), 70 (6), 72, 73, 75, 76, 78, 79



- For subordinated exposures:  $PD=EL$
- b) When using an advanced IRB approach, EL is to be broken down into PD and LGD.

#### **LGD**

- a) If the credit institution is unable to reliably estimate PD:
  - For exposures to senior enterprises:  $LGD=45\%$
  - For exposures to subordinated enterprises:  $LGD=100\%$
  - For dilution risks of purchased corporate and retail receivables  $LGD =75 \%$
- b) When using an advanced IRB approach, EL is to be broken down into PD and LGD.

#### **M**

If the credit institution is able to reliably estimate PD:

For drawn amounts, the weighted average maturity (M) of the purchased receivables, but 90 days at least.

For amounts not drawn:

- If the contract allows for repayment or amortisation before expiry or if it provides credit protection to the credit institution that has purchased the receivables, for a significant future deterioration of the quality of the receivables, then the rule for amounts drawn should be applied.
- If the contract does not meet the above conditions, then it is the sum of the term of the potential claim with the longest term under the purchase contract and the remaining term of the purchase transaction, but not less than 90 days.

### **5.6 Validation of purchased receivables**

302. In the course of validation, the HFSA examines the treatment of purchased receivable with the following considerations in mind:

Is it ensured that under all foreseeable circumstances the credit institution has legally enforceable ownership of the purchased receivables?

Are both the quality of purchased receivables and the financial situation of the seller and the portfolio manager monitored?

Is the correlation between the quality of the purchased receivables and the financial situation of the seller and the portfolio manager assessed?

Are the findings of the periodic reviews of the sellers and portfolio managers documented?

Are the characteristics of the pools of purchased receivables, including seller's arrears and bad debts, assessed?

Does the institution monitor single-obligor concentrations of purchased receivables?

Does the portfolio manager prepare timely reports on the ageing structure and the dilution of the receivables?

Does the credit institution have a system to detect deteriorations in the quality of the purchased receivables?

Does the credit institution specify in writing a receivables purchasing programme?

Does the institution regularly assess compliance with the internal ratings based approach?



## 6 REFERENCED STATUTORY REGULATIONS AND OTHER PROVISIONS

Act LI of 2007 (Act of Amendment No. I) on the amendment of Act on Credit Institutions and Financial Enterprises and certain acts on specialised credit institutions

Act IV of 1959 on the Civil Code (Civil Code - CC)

Act XLIX of 1991 on Bankruptcy Procedure and Liquidation (Bankruptcy Act - BA)

Act LIII of 1994 on Judicial Execution (Judicial Execution Act – JEA)

Act XLVIII of 1996 on Public Warehousing (Public Warehousing Act – PWA)

Act XXV of 1996 on the Debt Settlement Procedure for Local Authorities

Act XXX of 1997 on Mortgage Credit Institutions and Mortgage Notes (Mortgage Act – MA)

Act CXX of 2001 on the Capital Market (Capital Market Act – CaMA)

Act CXXXVIII of 2007 on Investment Firms and Service Providers on the Commodities Exchange, and the Rules for their Permitted Activities (Investment Services Act – ISA)

Act XLII of 1994 on the Hungarian Export Import Bank Plc and the Hungarian Export Credit Insurance Plc (Export Import Act – EIA)

Act XX of 2001 on the Hungarian Development Bank Plc (Hungarian Development Bank Act – HDBA)

Act C of 2000 on Accounting

Government Decree 196/2007 (July 30) on the Management and Capital Requirement of Credit Risk (DCRR)

Government Decree 200/2007 (July 30) on the Management and Capital Requirement of Operational Risk (Government Decree on Operational Risk – DOPR)

Government Decree 244/2000 on the Rules for Specifying the Capital Requirement Necessary as Collateral for Trading Book Positions and Risks and Currency Exchange Rate Risks and on the Detailed Rules for Maintaining a Trading Book (Government Decree on Trading Books – GDTB)

Government Decree 381/2007 on the Management of Credit Institution Counterparty Risk (Government Decree on Counterparty Risk – GDCR)

Government Decree 110/2006 (May 5) on the Procedures for the Preparations for Sovereign Suretyship and for the Cashing of Suretyship (Government Decree on Sovereign Suretyship – GDSS)

Directive 2006/48/EC of the European Parliament and of the Council relating to the taking up and pursuit of the business of credit institutions (CRD)

Directive 2008/49/EC on the Capital Adequacy of Investment Firms and Credit Institutions

Recommendation No. 11/2006 (December 14) of the Supervisory Council of the HFSA on the Establishment and Operation of Lines of Protection

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## 7 SOURCES

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2. Katalin Salamonné Solymosi: Collateral for Contracts, 1999.



## ANNEX 1 - CONSIDERATIONS FOR THE VALIDATION OF COMPLIANCE WITH THE REQUIREMENTS FOR FINANCIAL COLLATERAL

Review of the financial collateral part of the legal opinion:

- Have all eligibility and minimum requirements been addressed?
- Does the institution intend to enforce collateral eligible under the CRD?
- Have the characteristics of Hungarian regulations been taken into account?
- If the security deposit is not in the form of cash or a bank account balance, is there a publicly quoted market price available for the object of the security deposit?
- If a publicly quoted market price is not available, is there any other price that can be determined independently, and what is that independently determined price?
- If none of the aforesaid cases apply, does the contract provide that the creditor may seek satisfaction directly and has the mode of valuation been agreed upon?
- What procedures are in place for the monitoring of economic organisations in liquidation, for instance, is the Corporate Gazette (Cégközlöny) regularly monitored, and is the borrower obliged to give notification of any procedures commended against it?
- If the liquidation of a customer is published in the Corporate Gazette, is the three-month rule observed?

Review of the regulations for the valuation of collateral:

- What procedures are in place for the enforcement of collateral is there an accurate identification of dates, responsible persons and organisation units, and an accurate description of the process for the enforcement of the collateral, have deadlines been set in accordance with legislative deadlines?
- What collateral are intended to be enforced in respect of the magnitude of the individual transactions and of the exposure?
- Are risks arising from the use of collateral assessed, has the acceptable level of concentration and the dangerous level been specified in the internal regulations of the institution, have stress tests been conducted on the value of the collateral?
- The frequency of monitoring of changes in the value and enforceability of collateral, the documentation of monitoring, the identification of the responsible organisation unit;
- The procedure to be followed if there is a decline in collateral value;
- Do you intend to reduce the capital using collateral placed with a third party? If yes, the rating of the third party must be performed and documented, and you must indicate how collateral will be segregated from the other assets of the third party.

### *Considerations for the audit of compliance with requirements for real estate collateral*

1. Review of the legal opinion:

- Have all eligibility criteria and minimum requirements been addressed?



2. Review of internal regulations in accordance with the following considerations:

- Types of eligible real estate for the reduction of the capital requirement and the related credit policy (in respect of which transactions is real estate collateral proposed, what coverage requirements are imposed in respect of the magnitude of the risk taken);
- What databases are used and with what updates for the valuation of real estate collateral?
- Real property admissible as collateral but not acceptable, or only in special cases, as a risk mitigation factor for the calculation of capital, and the provisions for their separate treatment, documentation and registration;
- The system for the registration of collateral (identification of responsible persons, the content of the registration system);
- Provisions concerning the valuation of collateral (principles and techniques of valuation, the soundness of valuation methods, the data set used to establish the collateral value, the frequency of valuation, the instances of extraordinary valuation, the rules for on-site inspections and valuation, what is considered as the comparable data set if market prices change, what is considered as real property of such high value that requires the value estimate to be confirmed by an independent expert);
- The system of insurance for real property (depending on the nature of the property and the size of the credit);
- The procedure for the acceptance of collateral (with the identification of the responsible organisation unit(s), whether the legal department is involved, what steps are taken in the course of the acceptance of collateral);
- The procedure for the enforcement of collateral with consideration to the peculiarities of the Hungarian regulations;
- Is the lien contract recorded in an authentic public document?
- Was the minimum sales price of the property specified in the lien agreement, as well as the method of its calculation and the deadline for the sale of the pledged property by the lien holder?
- How does the institution verify whether a first lien has been secured;
- Is the monitoring of liquidation procedures that may be brought against the borrower ensured and how does the institution learn about them, how does it lodge its claims as a creditor?

***Considerations for the satisfaction of criteria related to unfunded credit protection***

- Charting the unfunded credit protection used by the institution, including the list of collateral used for the reduction of the capital requirement that can be classified here. To this end, it is necessary to review the regulations for the valuation of collateral and the legal opinion submitted by the institution.
- The legal opinion must address how eligibility and minimum criteria specified for unfunded credit protection are met. This is important because the institution must demonstrate to the HFSA that the requirements specified in the CRD for collateral are fulfilled. It is necessary to examine if the institution has addressed all eligibility criteria and minimum requirements.
- It is necessary to examine how collateral is registered, with what frequency it is monitored, what steps are taken and what procedures are followed if a deterioration of the collateral value is detected in the course of monitoring. It is important for responses to this to be rapid and organised. This, by all means, must be clearly visible in the regulations for the valuation of collateral. Regular monitoring and rapid action are important requirements because this



ensures that the institution takes appropriate steps to ensure that the collateral remains effective and that the related risks are managed.

- It must be examined which entities the institution recognises as providers of unfunded credit protection. What criteria are set with regard to protection providers? Are protection providers included among eligible protection providers?
- Examination of procedures for loans disbursed with sovereign guarantees (is monitoring of the achievement of the credit objective assured, and does the institution proceed with due care with regard to other collateral subject to the agreement)?
- Examination of the method for risk weighted exposure values and of the specification of the degree of possible recognition. This means the adequacy of the techniques for the calculation of the risk mitigation effect.

### ***Documents to be submitted***

- Legal opinion about the collateral that the institution intends to use as instruments of risk mitigation, with a detailed discussion of compliance with each requirement;
- Regulations for the valuation of collateral;
- Regulations for the assessment of loan security values;
- Model agreements for the proposed types of collateral.



## ANNEX 2 – REVIEW OF RISK MITIGATION TECHNIQUES

	STA		FIRB		AIRB
	Approaches that can be used to quantify of the risk mitigation effect				
	Simple	Comprehensive	Simple	Comprehensive	
	Maturity mismatch not allowed	Maturity mismatch allowed	Maturity mismatch not allowed	Maturity mismatch allowed	
Banking book					
Trading book					
<b>FUNDED</b>					
Financial					
Cash, bank deposits	The risk mitigating instrument takes the place of the appropriate portion of the exposure to be covered, with its own risk weight, substitution.	The risk mitigating instrument reduces the value of the exposure (E*) which is also adjusted with supervisory or own haircuts (for exposure, collateral, foreign currency)		Reduction of LGD in proportion of the adjusted exposure value (E*) to the original exposure (E) value (LGD* = E*/E), EAD remains the original exposure.	Own estimate for LGD*, EAD is the original exposure
Debt securities issued by central governments and central banks or by regional governments and local authorities or public sector institutions with identical risk weights.					
Rated (4) debt securities of multilateral development banks and international organisations with risk weights of zero.					
Rated (3) debt securities issued by institutions or by regional governments and local authorities or public sector institutions with identical risk weights.					
Rated (3) debt securities issued by other multilateral development banks.					
Rated (3) debt securities issued by corporations.					
Shares or convertible bonds included in a stock exchange index.					
Gold					
Not rated debt securities issued by credit institutions (subject to conditions).					
Investment notes (into recognisable assets).					
Shares or convertible bonds not included in a stock exchange index but quoted on a recognised exchange.					Own estimate for LGD*, EAD is the original exposure
Investment notes (into recognisable assets).					
Netting within the balance sheet (credit-deposit)		The balance is the cash collateral, E* net exposure value		The balance is the cash collateral, E*=EAD	Own estimate for LGD*, EAD is the original exposure
Master netting agreement		Supervisory or own haircut or internal model, E* is the value of the net exposure		Supervisory or own haircut or internal model, E*=EAD	Own estimate for LGD*, EAD is the original exposure
	<b>STA</b>		<b>FIRB</b>		<b>AIRB</b>
Real estate			LGD* is the supervisory LGD reduced depending on the level of cover, EAD is the original exposure.		Own estimate for LGD*, EAD is the original exposure
Receivables			LGD* is the supervisory LGD reduced depending on the level of cover, EAD is the original exposure.		Own estimate for LGD*, EAD is the original exposure
Movable property			LGD* is the supervisory LGD reduced depending on the level of cover, EAD is the original exposure.		Own estimate for LGD*, EAD is the original exposure
Finance lease			LGD* is the supervisory LGD reduced depending on the level of cover, EAD is the original exposure.		Own estimate for LGD*, EAD is the original exposure
Cash or deposit deposited with a third party	To be treated as a guarantee provided by the third party.				
Securities with put options	To be treated as a guarantee provided by the issuing institution, the extent of risk mitigation is either the nominal value or the market value.				
Life insurance	To be treated as a guarantee provided by the institution providing the life insurance, the extent of risk mitigation is the recovery value of the policy.				
<b>UNFUNDED</b>	<b>STA</b>		<b>FIRB</b>		<b>AIRB</b>
Guarantee, Suretyship	The risk weight of the guarantor / provider of credit protection replaces the risk weight of the original exposure, the exposure is adjusted using a currency haircut (supervisory or own) and for maturity mismatch.		A PD between the PD of the guarantor / provider of the credit protection or the PD of the obligor and the guarantor / provider of the credit protection is to be used, the exposure (EAD) is adjusted with a foreign currency haircut (supervisory or own) and for maturity mismatch.		Through adjusted PD and/or LGD, own estimates
Credit derivatives					