

Comments and proposals of the Hungarian Authorities concerning the third consultation paper of the Commission Services on the draft proposed risk-based capital requirements

The Hungarian Financial Supervisory Authority, the Magyar Nemzeti Bank (National Bank of Hungary) and the Ministry of Finance (hereafter: the Hungarian Authorities) make the following comments and proposals concerning the third consultation paper of the Commission Services on the draft proposed risk-based capital requirements issued in July 2003.

General comments:

The Hungarian Authorities agree with the main objective of the directive, namely to strengthen the relationship between regulatory and economic capital while ensuring a level playing field for all institutions, and maintaining the average level of capital in the financial sector.

In our opinion, the draft directive is a well-structured document with a simpler and more comprehensible wording compared to the Basel document. A considerable work has been done in streamlining the directive text, eliminating duplications and inconsistencies and enhancing the coherence and integrity of the draft. By providing the definitions of the used concepts and giving more accurate and detailed rules with examples facilitates considerably the implementation of the directive. The dual structure (articles+annexes) provides a flexible framework, as the amendment of provisions in the annexes by comitology procedure is a rapid and efficient response to market and regulatory innovations.

The draft directive diverges from the Basel document to a sufficient extent in order to take into account EU specificities and the wider scope, to reflect the differing characteristics of investment firms and smaller and less complex institutions. However, in order to assess more accurately the impact of the new regime on smaller institutions, further studies may be considered.

In our view, the number and scope of national discretions, beyond the need for flexibility, is still too wide in the current version of the directive. It increases the complexity and reduces transparency of the framework and furthermore, it can result in the geographical reallocation of business activities. To promote consistent application of the directive and ensure a level playing field, the number of national options should be limited by treating key areas on an EU level.

More detailed guidance is necessary in some areas raising implementation issues connected with the responsibilities and duties newly assigned to the supervisory authorities. These proposed guidelines should not necessarily be included in the directive text, but rather be elaborated by a group of experts charged with the treatment of implementation problems.

Specific comments:

Standardised Approach

Risk weighting of the sovereign

From 2006 Hungary's risk weight, similar to some other present and future EU member states, will rise from 0% to 20% as a result of the risk weighting system of the new capital regime. This considerable change occurs without any justification of deteriorating economic situation or any increase in risk. Additionally, this increased risk weight effects not only sovereign exposures, but exposures to institutions as well. Since all institutions operating in the EU are subject to the same prudential requirements and their supervision is carried out on the basis of the same principles, this significant differentiation in risk weights is not justified in the single European market and can cause competitive distortions.

For the above mentioned reason we propose that all EU member states should generally qualify for a 0% risk weight¹.

Mapping ratings into credit quality steps

The draft directive does not define the specific steps in the credit quality assessment scale which should provide the basis for mapping ratings into credit quality steps (CQS).

However, due to the possibility of mutual recognition of ratings across member states, it is crucially important that the mapping process for recognised ECAI ratings should be consistent so that ratings provided by different agencies and mapped into the same step reflect equivalent risk levels.

In order to ensure the consistent mapping of ratings into credit quality steps we suggest that the Commission define either the specific risk characteristics of a given step or give the corresponding default probabilities similarly to the Basle proposals.

National discretion to increase risk weight for retail exposures

The draft directive gives the competent authorities an option to increase the standard risk weights based on the overall default experience in their jurisdiction only in the case of corporate exposures. Nevertheless, this option to increase the risk weight is equally important in the case of the retail portfolio as well, especially in countries characterised by small company size where a large proportion of SME exposures can be classified as retail (it is included in the Basel document). Our understanding is that the sentence in point 8, Annex C-1 provides a discretionary power for competent authorities only in the issue of classifying the claim as a retail asset.

For the above mentioned reason the Hungarian Authorities propose to clarify this discretionary power and to give the competent authorities national discretion to increase

¹ An alternative approach could be if the preferential risk weight for sovereign exposures were mutually recognised. According to Annex C-1 1.2.2., the mutual recognition of Member States' national discretion is conditional upon denomination and funding. We suggest to extend this discretion to all types of sovereign claims on EU Member States whether or not they are funded in the same currency.

the 75% standard risk weight of the retail portfolio where they judge that a higher risk weight is warranted by the overall default experience in their jurisdiction.

IRB Approach

Partial use of IRB

We welcome the Commission's proposal on the combined use of standardised and IRB approaches, i.e. the possibility to apply the standardised approach permanently for exposures to institutions and sovereigns when satisfying certain criteria. The limited number of counterparties that can render the introduction of the IRB approach difficult or even impossible is an objective constraint that can arise not only in the case of the two asset classes, but in the corporate category as well. This is the case specifically in countries characterised by small company size, where a large proportion of small corporates is shifted to the retail portfolio.

The Hungarian Authorities suggest therefore, that for those institutions that operate with complex risk management systems, but at the same time due to the possible limited number of counterparties, are not able to introduce fully the IRB approach (lacking the sufficient volume of database), the partial implementation should be allowed for significant exposures in other asset classes as well. This would be allowed only in case of fulfilling strict criteria in order to avoid regulatory arbitrage.

Regarding the use of IRB approaches we also consider it crucial, what is the minimum amount of data on which an institution can build its internal rating model with a sufficient degree of reliability.

Revolving retail exposures²

Within the retail portfolio the draft directive defines a different risk weight curve to be applied to revolving exposures, which takes into account that in the case of these exposures the future margin income (FMI) covers expected losses. However, the criterion for the recognition of FMI is fulfilled in case of other retail exposures as well, so the exceptional treatment for revolving exposures exclusively does not seem reasonable.

The Hungarian Authorities suggest therefore the extension of this procedure to other types of retail exposures fulfilling the FMI recognition criteria, since the regulation in its present form may lead to the modification in the product structure of institutions.

Exposures to Small and Medium size Enterprises

In each of the three approaches to calculate capital requirement for credit risk, the required 1 million Euro exposure limit to be qualified as retail and the 50 million Euro total annual sales in the IRB approach for the firm-size adjustment influences countries with different corporate structure very differently. In countries characterised by smaller companies, the corporate asset class may be almost fully emptied due to the proposed limits.

In the opinion of the Hungarian Authorities, it would be reasonable to modify the defined limits in order to take into account not only the corporate structure of the

² The latest proposal of the Basel Committee may change this approach.

biggest economies. It is important however, that the eventually reduced limits remain consistent and maintain integrity so as to avoid regulatory arbitrage.

Relationship between provisions and capital; differences in regulatory approach

The regulatory framework of CAD3 and Basel II³ seems to be straightforward in its aim that the aggregated amount of provisions and capital should reflect the sum of expected and unexpected losses. The proposals make the links between the definition and allocation of provisions and capital tighter. For example, setting aside provisions influences the level of capital charges and triggers default events due to the reference definition of default. This approach could result in controversy and inconsistent treatment across the different Member States when put into practical use, since no equivalent rules for reserve or provision allocation exist within the Union.

Therefore, we suggest forming proposals for provision allocation methodologies and the accounting treatment at the European level, thus straightforward definitions and consistent rules could provide comparability of methods and data and a level playing field in reserve allocation.

Recognition of provisions (Annex D-6)⁴

According to Annex D-6, paragraph 1, specific provisions are recognised in the capital requirement calculation in a different way than in the Basel II proposals. In the Basel proposals, specific provisions decrease capital requirement only in the case of defaulted assets (para 344), whereas in the CAD3 no similar restrictions exist. As the definition of default makes it possible that setting aside specific provisions does not necessary trigger a default event, the differences in the wording could have an impact on provision allocation practices.

Regarding the IRB Advanced Approach, we would welcome this difference in provision recognition; however, we are concerned about the new incentives of provision allocation in the case of the IRB Foundation Approach. In respect of non-defaulted assets, differences in the ratio of expected losses and capital charge ($pd \cdot lgd / RW$) for the different portfolio segments result in various provision allocation practices for the different segments. In the IRB Foundation Approach, LGD values are fixed by the Basel Committee and are based on the loss data of G10 countries, thus they do not represent the real and actual values for a given country. Nevertheless, they could strongly influence reserve allocation policies.

“General provisions taken against credit risk in specific sectors” and “portfolio-specific general provisions” are mentioned in Annex D-6, para 4 and 5. In the European directives, this terminology is unknown, accordingly, **we suggest defining them and clarifying whether or not industry-specific provisions belong to these provisions.**

In Annex D-6, the term “general loan loss provision” is used; however, the European accounting directives and even 2000/12 define only “funds for general banking risks”. General loan loss provision is the terminology of the Basel Committee, and its allocation and accounting procedures are different from those prescribed in the European directives for the funds for general banking risk. **Please clarify the relation between the two definitions. In addition, we would welcome the amendment of the European directives with the concept**

³ The latest proposal of the Basel Committee may change this approach.

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of general loan loss provision. Thus, the different methods and definitions of each Member States could be replaced by an equivalent term within the EU.

Capital requirement for the portfolio of defaulted assets⁵

The European and Basel proposals prescribe the reallocation of specific provisions that exceeds the EL-portion of each individual risk weighted asset within the same asset class of defaulted assets (Annex D-6 para 2). As the PD for the defaulted assets is 1, the key input parameter for the capital requirement of defaulted assets will be the LGD. Due to the recognition rules of provisions, when the institution holds specific provisions equal to the LGD value, its capital requirement could decrease to 0. Thus LGD has special importance after the default event, whereas its value is still unsure. In addition, in the IRB Foundation approach LGD does not reflect the reference loss data of a given country, but the average of the G10 countries. **We do not support relying solely on fixed LGD values when calculating the defaulted assets capital requirement.**

In the IRB Advanced approach, we suggest the admission of specific provision reallocation only in cases when LGD reflects average values of either a given asset class or a subportfolio or an industry.

Credit risk mitigation

The draft directive recognises a wider range of risk mitigating instruments compared to the 1988 Basel Accord. The recognition of those instruments increases significantly the risk sensitivity of the regulatory capital requirement. Because of prudential reasons it is obviously important to set up eligibility criteria for these instruments. However, due to the present strict rules, some instruments which are used in some countries in a widespread manner may have remained outside the scope of eligible risk mitigating instruments. It would be especially important for institutions of certain countries that the directive recognise the simple surety of the central government (sovereign) when assessing capital requirements, since this instrument, used also widely in the Hungarian practice, results indeed in lowering the risk. The central government (sovereign) surety only in exceptional cases means cash surety as eligible instrument in the regulation.

The Hungarian Authorities suggest therefore, that the directive should give the option for the supervisory authorities to recognise partially the simple surety of the central government if this simple surety fulfils the strict criteria partially.

Sovereign counter-guarantee

Undertakings specialized for granting guarantee (not operating as credit institutions), which are usually backed by a solid government support, fall in the same category as well.

The Hungarian Authorities suggest, therefore, that guarantees provided by these guarantee institutions may be recognised by the supervisory authority as sovereign guarantee to the extent of the government support in cases when the counter-guarantee fulfils partially the given requirements.

⁵ The latest proposal of the Basel Committee may change this approach.

Market risks

Treatment of settlement risk in the trading book

The settlement risks in the trading book can be derived on the basis of 2 types of risk factors: 1) the probability of default of the counterparty (*credit risk factor*) and 2) risk arising from the price movement of the underlying asset (*market risk factor*).

The current regulation (CAD2), by defining the capital charge as the replacement cost multiplied with a factor proportionate to the number of working days after due settlement date, gives priority to factor 2) since does not consider the identity of the counterparty.

If CAD3 introduces a treatment for settlement risk which is consistent with the banking book treatment and abrogates Annex 2 of the CAD2 and, by doing this, gives priority to factor 1), then **we propose that the amount of the final charge should be determined by the following principles already existing in the CAD2:**

- **it should be proportionate to the number of working days after due settlement date;**
- **it should represent the replacement risk arising from the price movement of the underlying instrument.**

As the current regulation will cease to exist, the future of another important element would be put at stake. Namely, according to the CAD2, unsettled transactions generate no capital requirement at all within 4 working days after the due settlement date. In our view, a credit risk charge for this period is not reasonable, although, in theory, a credit risk-type risk can be connected to the counterparty. First, the loss arising from the relationship with trade counterparties also appears in the loss event-type classification for operational risk, which means that another type of capital charge is connected to these types of risks. We endorse this approach, because a failed settlement on professional markets with short settlement periods and frequent trading relationship occurs more probably for operational risk reasons, and the settlement is executed with a short delay. Second, if the execution of the settlement takes place on a delivery versus payment basis, then, after an unsettled transaction, the counterparties are only exposed to market risk arising from the price change of the underlying product.

Operational risk

Recognition of insurance

The draft directive recognizes the risk mitigation effect of insurance against operational risk only in the case of the Advanced Measurement Approach.

In our view the limited recognition of insurance as risk mitigating instrument should be allowed in the simple methods as well if certain criteria are met, since the amount of loss, covered by the capital charge related to operational risk, is always reduced by the use of insurance policies.

Once the risk mitigating effect of insurance is not recognized by the Commission, it would mean a double capital charge, since the same risk is covered by capital or reserves by institutions and insurance companies as well.

Of course, the recognition of insurance as a risk mitigating factor in the assessment of capital charges has to be conditional on the fulfillment of well defined criteria, such as: the definition

of eligible insurance companies, how to take into account the amount of retention when assessing the capital charge, or what terms are to be included into the insurance policy.

Investment firms

We support the proposal of the Commission that the different types of investment firms should be classified according to the risk inherent in their activities and those with limited license and providing low risk services should be subject to a preferential capital treatment. Furthermore, we welcome the mapping of investment services into business lines, which will facilitate the implementation of the directive.

On the basis of the principle of the European financial regulation, according to which similar activities are regulated by similar rules, the new capital regulation and the requirements for operational risk as a completely new element would be imposed on the investment firms as well. Based on a Hungarian survey, which has used the methodology of ISPA assessment we can fully endorse the new proposal to waive companies with limited license (50K and 125K firms) from the operational risk charges. Since the waiver cannot be applied to institutions belonging to financial groups holding a credit institution, for these investment companies the increase in capital charges can rise extremely high. For those investment firms carrying out activities other than the limited range (730K firms), given that they can not be exempted, a significant increase in capital requirements can be anticipated as well. These firms can only alleviate the capital burden on themselves by applying the Advanced Measurement Approach (AMA). Nevertheless, to construct the prescribed database and to elaborate the required, adequately robust internal model is not a valid alternative, taking into account the Hungarian circumstances for the near future. **For those less complex but professional investment firms that are active only on local markets, we propose to build in more alleviation into the qualifying criteria for AMA.**

Supervisory review process

Scope and transparency of national discretion

In the view of the Hungarian Authorities the current proposal still allows for a wide range of national options that may endanger the coherent application of the directive and can result in the geographical realignment of business activities within the EU. Having accepted the need for national discretion allowing for taking into account the specificities of local markets and enhancing competitiveness, the Hungarian Authorities still believe that the current number and scope of national discretions is still too wide and should be limited. This limitation, that is, common EU standards in key areas would encourage the coherent application of the directive and would help to avoid competitive distortions and regulatory arbitrage.

Additionally, the Hungarian Authorities find very important the transparency of decisions taken at national discretion in order to make regulatory differences more visible. Supervisory disclosure would promote the harmonisation of supervisory practices and help the recognition of preferential treatments.

Transparency and accountability

The Hungarian Authorities agree with the proposal of the Commission regarding supervisory disclosure that the requirements to hold an amount of own funds higher than the minimum level as defined in Article 3 shall not be published. This rule does not mean however that the competent authorities, apart from the above mentioned requirement, would be prevented from disclosing their supervisory decisions.

Principle based approach of Title III

We maintain that the general requirements based on principles of Title III are inconsistent with the detailed and sophisticated rules of Title II. The extremely wide possibilities of supervisory discretion could even damage the reliability of financial law, which is one of the main pillars of the rule of law. The current proposal does not give proper guidance for the supervisory assessment of those authorities, which already have expertise in discretionary power. In addition, those countries which do not support supervisory discretion do not enjoy a level playing field. It could create different playing fields when the evaluation processes and prudential measures of one authority should be fixed and published a priori, whereas the other authority has greater flexibility in the assessment of the different institutions. This problem affects not only Hungary, but also the Member States whose legal system is different from the common law and does not support discretionary legal power. The proposal of the European Union could reduce this difference with more detailed guidance on risk evaluation procedures of Title III and also could create greater transparency in the supervisory review process.

Management of risks listed in Annex I

We are proposing that the evaluation and review of interest rate risk and residual risk should be based on national discretion rather than on supervisory discretion, and that the main steps of stress tests should be prescribed. These types of risks are common for the institutions within a Member State; therefore, we suggest distinguishing these risks from the others in Annex I and defining the related evaluation processes and prudential measures in more detail in the Annexes of the proposals.

We suggest that responsibilities of competent authorities related to the risks mentioned above should be incorporated into Article 5. In our opinion, the requirements of these risks should not be part of minimum requirements, but failure to fulfill these requirements should imply prudential measures by the authorities.

Title IV – Market discipline

According to Article 137, the competent authorities shall request the parent institution of a consolidated group to publish disclosure requirements. The authorities shall also require public disclosure on a subconsolidated or individual basis with regard to their significance. Thus, the European proposal is more stringent in this aspect than the new Basel Accord, which only requires disclosures at the top holding level. **We suggest in the European proposal that the competent authorities may require public disclosure also from the subconsolidated groups or individual institutions, if they are significant based on their market share in the Member State.**

Other important issues related to the implementation of the directive:

In our opinion, more detailed guidance is necessary in the following areas concerning the implementation of the directive, with the particular importance on the new responsibilities and duties assigned to the supervisory authorities. These proposed guidelines should not necessarily be included in the directive text, but rather be elaborated by a group of experts consisted of the delegates of member states and charged with the treatment of implementation problems, ensuring a consistent interpretation and elaborating guidelines. As a common interest, the elaboration of these guidelines on EU level has fundamental importance in that the differing supervisory practices can endanger the consistent implementation of the directive giving rise to regulatory arbitrage.

Application of parent company IRB models by subsidiaries

In our view the Commission should elaborate detailed guidance on the **supervisory approval process for internal rating models in such cases where the model has been developed by the parent company and the institution intends to apply it in its subsidiaries**. This guidance should specify the forms of cooperation between the supervisory authorities concerned and clarify their duties with regard to the approval process and the application of the provisions regarding data requirements.

Common database for IRB

The draft directive does not give detailed guidance on the criteria how to establish a **common database (datapool) by institutions or groups of institutions that operate in one country or in more countries**, and the data requirements of the IRB approaches when assessing capital requirements. This question arises because the directive does not define the concept of the relevant market upon which the required database can be built. Providing this definition would be important from another aspect as well, namely that the new regulation should ensure a level-playing field for groups with different legal structures (subsidiaries or branches).

It is also crucial in the establishment of a common database whether it can be created by any group of institutions or should any limitation be set up there. It is an often raised question in international fora whether it is allowable for banks in a competitive position to establish a common datapool. While the opinions of experts are quite divergent in this question, we request the Commission to indicate its position on this issue.

Guidance on databases for operational risk for using AMA

The draft directive gives only general guidance on the Advanced Measurement Approaches. In our view it is essential to **elaborate more detailed and specific requirements related to the practical implementation of AMA approaches**. Such requirements should for example specify the sufficient amount of data in order to produce reliable estimates, the criteria on the scope of data to be used for the development of groupwide models and relating to their application by subsidiaries.

Cooperation between supervisory authorities

In our opinion more guidance is needed regarding the international cooperation of supervisory authorities, since there are several issues in the directive having international aspects. Such

issues include e.g. mutual recognition of preferential risk weights and external credit assessment agencies, in the case of internationally active groups the application process for the use of advanced approaches and the ongoing review of the compliance with minimum requirements. Therefore, **the forms of cooperation among supervisory authorities should be specified with clear division of duties and the application of general rules for situations involving supervisory authorities from different jurisdictions.**