



**PÉNZÜGYI SZERVEZETEK
ÁLLAMI FELÜGYELETE
HUNGARIAN FINANCIAL
SUPERVISORY AUTHORITY**

**Information
on High-Risk Portfolios and on Related Additional Capital Requirement as
Key Priorities in the Supervisory Review Process (SREP)**

11 June 2010

Annex 1 is part of the guidelines for the Supervisory Review Process (SREP), in which document those risks and high-risk portfolios are reviewed, with regard to which additional capital is required by the Hungarian Financial Supervisory Authority (hereinafter HFSA) in the calculation of the internal capital requirements of the institutions and with regard to which this will be controlled with increased attention in the course of the SREP. The high-risk portfolios disclosed herein will be reviewed by HFSA annually and may also be modified at other times on an ‘as needed’ basis.

The high-risk portfolios disclosed under Pillar Two are always related also to the [priorities, announced by the HFSA](#).

The Supervisory Authority lists such risks in high-risk portfolios which, according to the analysis–supervisory information, exist in the Hungarian market and give reason to special supervisory concern, and where for the management of which the involved institutions are expected to reserve additional capital on the basis of SREP. By enforcing this requirement, we basically wish to achieve several supervisory goals:

- With regard to certain risks, we wish to call the attention of the involved institutions to that we regard the risks inherent in the activity that they perform as so significant that we think it is justified to generate surplus capital for their coverage, the extent of which, however, we have defined in the range between 0-100% tied to the standard of the applied risk management methods. In the case of those institutions where the applied risk management methods are high standard, and they comply with the relevant supervisory recommendations, there is a 0% additional capital requirement, while the same is 100% in the case of weak risk management.
- In the case of certain risks (product, activity, practice), the supervisory goal is to protect the market from the uncontrolled spreading of the risk. In this case, we find the risk so significant that it carries serious threats for the institution in question, the clients of this institution and the market as a whole, even with advanced risk management methods in place. In the case of these risks, a 50-100% additional capital requirement is applied in line with the standard of the applied risk management method, in order to cover the risks by an appropriate amount of capital.
- In the case of certain risks according to the changing risk environment HFSA considers necessary to draw the attention of each interested market player to the increased risks and the need for extra capital to cover these risks. In these cases a uniformed method is applied to calculate the additional capital requirement.

Besides the risks indicated here, the Supervisory Authority monitors the high-risk portfolios indicated in the Annex of the CRD in the framework of Pillar One, as long as capital for these portfolios has to be created under Pillar One, pursuant to the CRD, and accordingly, to the provisions set out in Article 16 (1)–(2) of the Hkr. (Government Decree on credit institutions).

In this document, effective from 11 June 2010, we also cover the risks and, within those, the inherent risk or risk control applied by the Supervisory Authority in its classification of the exposures and high-risk portfolios, thus assisting the ICAAP analyses of the institutions.

Parallel with the changes of market processes and regulatory requirements, the scope of portfolios deemed as high risks under SREP has been modified several times. In the analyses, the Supervisory Authority expects each institution concerned to be able to present in detail its method of managing the high-risk portfolios specified in the Guidelines in ICAAP. The Supervisory Authority proceeds in accordance with the provisions of the Guidelines effective

at the time of building of the portfolios in each case,¹ The previously published Information is available on the Supervisory Authority's website under the menu point Regulatory instruments/Supervisory methods in the [Archive](#) folder.

Government Decrees No. 361/2009. (XII.30.) on the conditions of prudent retail lending and creditworthiness examination and No. 109/2010. (IV.9.) on the commission of intermediaries of financial services specify numerous conditions at the level of legal regulations which force institutions to apply more prudent procedures. The additional capital requirements must be applied in compliance with the effective dates specified in the Government Decrees.

In line with the principle of the neutrality of the competition and equal treatment, the Supervisory Authority continues to deem the expectations part of the public good², and therefore it applies them equally to all relevant market actors. This also means that the Supervisory Authority expects actors of the monetary and capital market, not falling within the scope of consolidated supervision in Hungary (including also branches active in Hungary) to behave in compliance with the provisions of the Government Decrees referred to above and the following requirements, which are enforced by it with other supervisory means or within the framework of its international co-operation.

Risks handled by the Supervisory Authority as priority, which may occur at the institutions in the scope of the CRD

Loosening of lending conditions

Related supervisory priority announced for 2010: liquidity, credit risk, responsible lending
Risk classification: credit risk, inherent risk

It is regarded by the Supervisory Authority as loosening of the credit conditions if the following are listed among the product conditions:

1. prolongation of terms, not in harmony with the life of the financed asset;
2. grace period of several years, extending both to the interest and the principal;
3. repayment at the end of the duration (balloon payment).

With regard to the easing of credit conditions, the supervisory objective is to protect the market against the uncontrollable spread of risks. The Supervisory Authority will apply the measure following the disclosure of the relevant guidelines on high-risk portfolios.

The additional capital requirement that can be set on the basis of institution-specific data is 50-100% of the capital requirement of the portfolio concerned under Pillar One.

¹ Any new legal contract (new loan/facility agreement, prolongation, renegotiation, renewal, etc.) concluded after the entry into force of the various Guidelines need to be considered portfolio building.

² According to the EU Commission's [explanation No. 97/209/6](#), the following constitutes protection of public good: 'Protection of clients, employees, social security, consumers and the assessment of the Hungarian financial sector, the social order, intellectual property, cultural policy, national historical and artistic heritage, the consistency of the tax system, road safety, creditors and justice, as well as prevention of fraud.'

Refinancing of financial enterprises offering mortgage loans and performing work-out activities

Related supervisory priorities, announced for 2010: credit risk/responsible lending, customer protection

Risk classification: credit risk, risk control

In the Hungarian financial sector, the credit approval, rating and risk monitoring procedures applied by financial enterprises have been different from the banks' practice and therefore the easing of credit conditions resulted in increased risks in the asset quality of financial enterprises and indirectly also at the funding (refinancing) credit institutions. Parallel with the risk of asset quality deterioration, there was a high increase in the number of complaints in the area of consumer protection in relation to the violation of the provisions of the Consumer Protection Act.

In order to boost the growth of the mortgage loan portfolio, such dynamic expansion was observed in the Hungarian financial sector during the last few years at the financial enterprises offering mortgage loans which could only be achieved by extending the eligibility for loans to borrowers with lower ratings and by easing the conditions of lending.

The HFSA's objective was to ensure that credit institutions financed only financial enterprises that applied prudent lending practices and complied with the provisions of the applicable laws and the Code of Conduct. The HFSA did not intend either to cause competitive disadvantages to compliant entities or to slow down the growth of well functioning, careful and prudent financial enterprises in the sector.

At the same time, through the availability of refinancing the HFSA intended to make more difficult the operation of mortgage lending financial enterprises that pursued irresponsible practices and abused their creditor position and market power by setting an additional capital requirement for refinancing credit institutions.

Concerning financial enterprises that are members of banking groups, only those institutions were eligible for applying the zero risk weight category stipulated in Article 76/A (7) of the ACI, based on a permission granted by the Supervisory Authority, which also complied with the Code of Conduct in addition to the conditions set out in the relevant laws and regulations. Already issued licences may be revoked.

Based on its negative experiences, the Supervisory Authority wishes to prevent the protraction of the management, discovery and realistic representation in the books of the actual problems, through investments into workout companies, or financing these. However, the Supervisory Authority does not aim to make the performance of this activity impossible, thus the additional capital requirement will only be required on the basis of assessing the specific cases and circumstances. The Supervisory Authority wishes to pay extra attention to the management of these portfolios in the capital requirement review process.

The additional capital requirement that can be set on the basis of institution-specific data is 50-100% of the capital requirement of the portfolio concerned under Pillar One.

Refinancing of the activities of financial enterprises by credit institutions with lower than HUF 1 billion capital

Related supervisory priority announced for 2010: credit risk/responsible lending

Risk classification: credit risk, risk control

In view of the risks associated with the activities of financial enterprises and the control thereof, if credit institutions with less than HUF 1 billion capital refinance a financial enterprise, then the Supervisory Authority expects and controls that such credit institutions

assume only such risks which are proportionate to their risk management procedures and risk assessment activities.

The additional capital requirement that can be set on the basis of institution-specific data is 0-100% of the capital requirement of the portfolio concerned under Pillar One.

Lending in a country with a lower sovereign credit rating to resident debtors

Related supervisory priority announced for 2010: liquidity, credit risk/responsible lending

Risk classification: credit risk, inherent

Lending to debtors in countries of emerging markets is an opportunity that seems to be favourable for Hungarian creditors both for the achievable growth in volumes and for the interest margins. However, fast credit expansion carries risks for the macro-economy and financial stability, and high interest margins mean a further risk factor besides the direct trading risk of the credit in the case of target countries with lower sovereign credit rating – it leads to a further risk, i.e. the country risk that characterizes the macro-economic stability of the target country and the transfer risks related to the debt service payments. From this aspect, the credit receivables from the residents of target countries with sovereign credit risk rating lower than that of Hungary represent a higher credit risk level than the Hungarian receivables of similar trading risks.

In the case of loans granted to debtors resident in countries with lower sovereign credit rating, the supervisory goal is to draw attention to the high risk level of the activity. According to the ICAAP logics, it is justified to reserve additional capital for high risks. As the ICAAP Guidelines provide detailed information on the management of country risks the additional capital requirement to be set can be calculated on the basis of the following two methods:

1. In the ICAAP-SREP Guidelines, according to the provisions that refer to the country risk capital requirement.
2. In the case of institutions that apply their own method, which is different from this but is accepted by the Supervisory Authority, it is required that the extent of the surplus capital should reach or exceed 30-100% of the capital requirement calculated on the basis of the provisions set out in the ICAAP-SREP Guidelines, on the basis of the institution's own method as well.

Calculation of capital requirement of foreign exchange risk under volatile market conditions

Related supervisory priority announced for 2010: liquidity, credit risk/responsible lending
Risk classification: market risk, inherent

The Supervisory Authority considers that currently the VaR model provides an economically more appropriate capital requirement, therefore we consider it necessary for every bank as part of the SREP review process to calculate the capital requirement of the exchange rate risks with a (supervisory) model with the same formula and method of calculation for the same period and that the amount calculated with the model which exceeds the results calculated with the standard method should be the additional capital requirement for the banks, calculated under SREP. The (supervisory) model can be downloaded from the HFSA's website.

In compliance with the provisions of Article 39 (3) of Government Decree 244/2000. (XII. 24.) on the rules of establishing the capital requirement for covering the positions and exposures registered in the trading book, the exchange rate risk and large risks, and on the detailed rules of keeping the trading book, if the currency position of a credit institution, opened according to the decree referred to above is lower than 2% of the guarantee capital of the institution before the deduction of any excess, then the exchange rate risk does not have any capital requirement in Pillar 2 either.

In our opinion, there is no need to apply this to co-operative credit institutions as a mandatory requirement, because at the moment the risk in this field is not significant.

Cross-border services and branch opening in a foreign country of credit institutions with less than HUF 1 billion capital

Related supervisory priority announced for 2009: strategy
Risk classification: corporate governance, control

In the opinion of the Supervisory Authority, the provision of cross-border services and the opening of branches abroad require significant extra professional and infrastructural resources, which can only be provided appropriately by credit institutions with a capital supply higher than the minimum capital level stipulated in the law. This is why the Supervisory Authority does not think that credit institutions with a guarantee capital amount lower than one billion Forints should launch cross-border operations, or open branches abroad.

The additional capital requirement that can be set on the basis of institution-specific data is 50-100% of the capital requirement of the portfolio concerned under Pillar One.

Factoring portfolios at credit institutions with less than HUF 1 billion capital

Related supervisory priority announced for 2010: credit risk/responsible lending
Risk classification: credit risk, control

The priority treatment of the factoring portfolios is justified by that the credit institutions, more precisely, primarily the credit associations with a relatively lower capital supply, have incurred considerable losses in the factoring sector in the past few years. However, the Supervisory Authority does not aim to create a competitive disadvantage for the institutions that perform their activities in this, otherwise important, sector prudently, in a 'classical' manner.

The additional capital requirement that can be set on the basis of institution-specific data is 0-100% of the capital requirement of the portfolio concerned under Pillar One.

Retail car financing

Related supervisory priority announced for 2010: credit risk/responsible lending

Risk classification: credit risk, control

The Supervisory Authority deems any retail car financing transaction risky (both in the case of a loan and leasing) if the risks described in the easing of credit conditions on Page 3 of the Guidelines or if any of the following conditions prevails:

1. the age of the passenger cars during the term of financing exceeds the average age published by HCSO (Hungarian Central Statistical Office) for the year prior to the contract, which was 11 years in 2009³. The mandatory additional capital is 50% of the capital requirement of the affected portfolio under Pillar One between 11 and 15 years and 100% of the same capital requirement over 15 years;
2. the age of the commercial vehicles during the term of financing exceeds the average age published by HCSO (Hungarian Central Statistical Office) for the year prior to the contract, which was 10 years in 2009. The mandatory additional capital is 50% of the capital requirement of the affected portfolio under Pillar One between 10 and 12 years and 100% of the same capital requirement over 12 years;
3. during credit approval, the financier did not receive at least one of the following documents, required for establishing the customer's paying capacity:
 - income certificate;
 - bank account statement for the previous two months, containing also an income certificate;
 - an APEH income certificate issued by APEH for the last closed tax year;
4. the financing institution does not control its employed agents regularly, at least once a year, in a manner supported with documents,
5. the control of agents by the financing institution does not include at least
 - the customer information, including especially the information required by law,
 - the authenticity and completeness of the documents which must always be presented to the financier,
 - full compliance with the supervisory guidelines,
 - investigation of customer complaints;
6. commission is paid also for the outstanding term in the case of prepayment, or some other fee substituting such commission is charged,
7. the principal amount of the customer's loan does not decrease proportionately during the term of the transaction or instrument (with the exception of the products designed according to the annuity rules),
8. the instrument does not contain all components of the commission/⁴fee payable to the agent in a documented manner, required by law,
9. the transaction/instrument does not contain the price of the vehicle applicable to cash payment or a detailed comparative statement of the related costs occurring during the

³ Based on the data of the European Environment Agency, according to the figures of the EU 27 countries, as well as Norway, Switzerland, Turkey and Croatia, in 2008 the European average was 8 years.

term of the various loan and leasing instruments (products), including especially the size of repayments, the APR and the total amount of loan repayments/lease fees as well as the own funds,

10. in an instrument with fixed repayments (so-called fixed price) the unfavourable and favourable impacts of any exchange rate change are not equally applied to customers,
11. if in instruments with fixed repayments the term of the loan is defined at the time of the conclusion of the loan/leasing agreement, whereby as a result of any potential negative changes the total term of the loan exceeds 84 months, specified in the 361/2009. Government Decree as a result of the measures introduced in order to reduce the customer's payment obligations;
12. during the term, the actual outstanding principal debt is higher, at any time, than the principal debt calculated with the term and equal (annuity-based) monthly repayments, based on an instrument with the same transaction interest rate for a particular time under Article 7 (5) of the 361/2009 Government Decree.

The additional capital requirement that can be set on the basis of institution-specific data (where it is not stated separately): 50-100% of the capital requirement of the affected portfolio under Pillar One.

⁴ The provisions on the contract continuation commission advance contained in the previous Information of the Supervisory Authority were overwritten in the 109/2010 Government Decree of 9 April 2010. Article 6 of the Government Decree states that in the case of passenger car and small commercial vehicle loans, financial leasing and loan agreements secured against vehicles (hereinafter together car financing contracts), the contract continuation commission must be at least 70% of the total commission and is payable regularly during the entire term, **in proportion to the contractual performance of the mediated financial service by the customer**. If the payment costs related to the small commission payable to the agent are disproportionately high, the Supervisory Authority also accepts **subsequent** aggregate commission payments.

EUROTAX sales price, applied in the calculation of the market value

Article 2 point 3 of the 361/2009 Government Decree defines the market value of vehicles:

- for new vehicles, the market value is the gross purchase price of the vehicle which, in the interpretation of the Supervisory Authority, is the official listed price of the vehicle, less the documented preferences attached to the contract (the documentation must contain reference to the price registration)
- for second-hand vehicles, the market value is the sales value calculated in the vehicle valuation system containing a database of internationally traded vehicles, used and accepted by the entire vehicle segment both in Europe and in Hungary. In this context, the Supervisory Authority expects the following price calculation.

EUROTAX sales price: the gross sales price of the vehicle, which may not be increased with any special VAT.

Only the EUROTAX database/catalogue applicable at the time of acceptance of the financing offer/request, or valid no more than 2 months before the submission of the offer/request may be accepted as the EUROTAX version, used in the approval of the financing offer/request.

The EUROTAX sales price, i.e., the 'Eurotax full sales value' relates to

- the price calculated on the basis of
- the status classification and the date of first licensing for traffic,
- the extra accessories, increasing the sales price and the actual mileage.

The local popularity, the sales premises and other value adding adjustments cannot be used as price correction factors.

The calculated sales price of vehicles which cannot be identified in the Eurotax Car Value Programme may be accepted based on an individual valuation prepared by EUROTAX/Origin Verification Station.

The document used for the price calculation must be retrievable.

A trade association or independent organisation may also specify more detailed rules and, if they are published, the Supervisory Authority applies the stricter provisions between the two regulations down to the level of details.