



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

The Supervisory Review Process (SREP)

GUIDELINES

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Abbreviations

AIRB	Advanced Internal Rating Based Approach
AMA	Advanced Measurement Approach
ALCO	Asset Liability Committee
ASA	Alternative Standardised Approach
BCM	Business Continuity Management
BIA	Basic Indicator Approach
CEBS	Committee of European Banking Supervisors
CCP	Central Counterparty
CRD	Capital Requirements Directive
DVP	Delivery versus Payment
FIRB	Foundation Internal Rating Based Approach
ICAAP	Internal Capital Adequacy Assessment Process
IRB	Internal Rating Based Approach
SD	Settlement day
SREP	Supervisory Review and Evaluation Process
RVP	Receive versus Payment
TSA	The Standardised Approach
VAR	Value at Risk
CRCU	Credit Risk Control Unit
EH	strong effect
KAH	below medium effect
KEH	above medium effect
GYH	weak effect

1 Introduction

Supervisory Review Process (SRP)¹: The CRD contains directives about the supervisory review of the capital situation of institutions² so that it could be determined whether they have enough capital to cover their risks, taking into account the applied strategy, regulations, established processes, procedures and mechanisms.

Pursuant to the directives of the CRD, during the supervisory review of institutions and groups the supervisory authority must verify, based on the applied strategy, regulations, established processes, procedures and mechanisms, whether or not the institution or group has sufficient capital to cover its risks.

The SRP – Supervisory Review Process covers the whole supervisory process, in the course of which the supervisory authority reviews the risks of the institutions and their capital adequacy, intervenes at the right point of time to maintain the proper capital level, and continuously monitors compliance with Pillar 1, and with the validation.

The elements of the Supervisory Review Process³ include the review of the exposure of the institution to material risks (risk profile), the examination of the proper and reliable nature of the internal governance and internal capital adequacy process, and the examination of compliance with the minimum requirements of the legal regulations.

Based on the supervisory review and evaluation, the supervisory authority has to determine whether the regulations, strategies, procedures and methods applied by the credit institution, and its own funds will ensure the coverage and reliable management of the risks.

The Supervisory Authority defines the frequency, extent and depth of the review and the evaluation according to the importance, nature, volume and complexity of the credit institution and its activity, but the review and the evaluation have to be carried out at least once a year.

In the course of assessment of the capital requirement in Pillar 2, the Supervisory Review and Evaluation Process lays the emphasis on the importance of analysing the *qualitative factors*, i.e. the quality of the internal procedures and the degree of advance of the established risk management and rating systems are of primary importance in the determination of the capital requirements of the institutions in proportion to their assumed risks.

In order to capture these qualitative factors, the Basel Committee has identified the four principles of the supervisory review process:

- I. **Own risk and capital adequacy measuring by institution:** *Institutions should have a process for measuring their overall capital adequacy and a strategy for maintaining their capital levels that are in line with their risk profiles. (ICAAP).*
- II. **Supervisory review of the internal processes of institutions:** *The supervisory authority should review and evaluate institutions' internal capital adequacy calculations and strategies, as well as their ability to monitor and ensure their compliance with the regulatory capital ratio requirements. The supervisory*

¹ Supervisory Review Process

² 2006/48/EC Article 124.

³ Article 145/A of Act CXII of 1996 on Credit Institutions and Financial Enterprises (hereinafter: CIFE Act)

authority should apply measures if it is not satisfied with the result of this process.(SREP).

III. Capital over the regulatory minimum level: *Supervisors should expect institutions to operate above the minimum own funds requirements and should have the ability to require them to hold capital in excess of the minimum.*

IV. Intervention by the supervisory authority: *Supervisors should seek to intervene at an early stage to prevent capital from falling below the minimum levels required to support the risk characteristics of a particular institution and should require rapid remedial action if capital is not maintained or restored.*

The third principle reflects that each institution should have additional capital to cover risks not fully covered or not covered at all under Pillar 1. The capital requirement calculated under Pillar 1 is to cover the credit, market and operational risks. Consequently, each institution should have capital adds-on to cover risks not fully covered or not covered at all under Pillar 1. In order to make sure that institutions have a capital level higher than the regulatory minimum level, the supervisory authority may select from several methods.

The Hungarian Financial Supervisory Authority wishes to facilitate the compliance with the third principle, so every year it publishes the list of portfolios, activities, etc. that it believes to represent high risk under the market processes that can be observed in the given year, so it prescribes capital adds-on for these portfolios during the SREP. The supervisory authority published the “high-risk portfolios” document prepared for each year on its website.

For the implementation of the fourth principle, the supervisory authority has a wide range of tools to maintain the capital adequacy of the institutions, and can select the tool that in its views fits best the circumstances of the given institution. Supervisory measures can be for instance: limitation of the payment of dividends, demand for a plan to restore capital adequacy, requirement for the development of internal processes and procedures, prescription of supplementary capital. However, it is important to note that the prescription of capital adds-on will not solve the deficiencies in the systems and procedures of an institution, so it will be necessary to apply supervisory measures for eliminating the shortages as well.

2 General expectations - Principles

This chapter describes the general guidelines that have been worked out by CEBS, and that have been adopted and used by HFSA, too, in its supervisory review (SREP) processes.⁴ This is a list and detailed description of the 10 guidelines that should provide guidance in the supervisory review and evaluation processes.

SREP 1: The supervisory review process is an integrated part of the overall risk-based supervisory methodology.

⁴ CEBS GL 03 – Guidelines on Supervisory Review Process

The supervisory authority has to regularly review the capital adequacy measuring processes, the risk positions and the level and the quality of the calculated own funds of the institutions. The supervisory authority has to assess whether the internal capital adequacy assessment process of the institution is prudent enough (accuracy and completeness of data, relevance of main assumptions and correctness of scenarios), and whether the calculated capital requirement of the institution is suitable for the risk profile. The examination has to focus on the quality of the risk management systems of the institution, but the supervisory authority cannot substitute the management of the institution in the development of these systems.

SREP 2: The SREP should apply ⁵ to all group members.

Institutions under consolidated supervision are part of the SREP, i.e. financial enterprises (and associated companies) which do not fall under the scope of CRD directly, but because of the consolidated supervision of their parent company, are also covered by the SREP (e.g. leasing companies, factoring companies).

SREP 3: SREP should cover all the activities of an institution.

The full scope of activities of an institution also covers all the activities that are outsourced and not performed by the institution itself. These include the activities performed by external companies on an out-sourced basis (software development and maintenance, statement printing and mailing, ATM operation, document storing, cash and securities transport, cash processing and safe deposit services), and the activities that are centralised within the Group (e.g. controlling activities performed at regional level or centrally).

SREP 4: The SREP should be comprehensive and should cover every detail: it should cover all material risks and internal governance of the institution.

The supervisory authority evaluates the risk factors and the control mechanism of the institution, i.e. the purpose of the evaluation is to identify the risk profile of the institution and the adequacy and quality of the related risk management system. In the examination of the risk management system, the quality of the operation of the responsible internal governance: the company structure, the organisational structure, the structure of the management body, the control and supervisory functions and the internal control mechanisms, i.e. the quality of risk management and control environment, internal audit and compliance functions should be considered. The review should reveal control mechanisms to mitigate the risks, and should evaluate the adequacy and composition of capital held against those risks. The supervisory authority should identify whether the internal systems of the institution capture the risks emerging during the operation of the institution, and should evaluate the internal regulations regarding the risks (set up and control risk limits). However, no bigger capital may substitute for inadequate internal processes.

The evaluation process should be forward-looking in the sense that it should consider not only the risk profile at the given point of time, but the changes expected until the next evaluation, too.

⁵ The internal capital calculation refers to all institutions covered by CRD, but the ICAAP-SREP covers the financial enterprises under consolidated supervision as well, because of the consolidated supervision of their parent company.

SREP 5: The SREP will assess and review the institution's ICAAP.

The ICAAP review considers the assumptions, components; methodology etc. used for internal capital calculation, and assesses the risk management systems described in the previous point, as well as the assessment of the adequate capital.

SREP 6: The SREP will assess and review the institution's compliance with the minimum requirements laid down in the CRD.

Compliance with the requirements related to the methods of calculating the minimum capital requirement,⁶ the control and risk management stipulations and the disclosure under Pillar 3 are also examined within the framework of the supervisory review process. In the case of advanced methods (credit risk – IRB, operational risk – AMA), the supervisory authority has to make sure that the institutions continuously observe the requirements identified by the domestic legal regulation, both at the time of the introduction of the methods, and later on.

SREP 7: The SREP should identify potential problems and key risks faced by the institution and deficiencies in its control and risk management frameworks. As a result of the process, the SREP should assess the degree of reliance that can be placed on the outputs of the institution's ICAAP by the Supervisory Authority.

Based on the results of the review process, the Supervisory Authority will formulate its supervision strategy related to the institution, the supervisory actions to be taken, and also supports and helps the improvement of the risk management systems of institutions.

SREP 8: The SREP will inform supervisors about the need to apply supervisory measures.

The end result of the review is an evaluation of the fact whether or not the institution has adequate capital to cover its risk profile. If the supervisor finds that more capital is required, or there are deficiencies in the control mechanisms, a relevant supervisory measure should be initiated, and its time frame should be determined, too.

SREP 9: The results of SREP will be communicated to the given institution.

The results of the supervisory review will be communicated to the institution at the appropriate management level, which may be done as part of the dialogue between the Supervisory Authority and the institution. The objective of the dialogue between the Supervision and the institution is to compare the supervisory expectations with the risks and the methodology considered by the institution in the completion of the ICAAP.

SREP 10: The supervisory review process should be performed annually, in order to keep the evaluation up-to-date and accurate.

The annual review does not necessarily mean the performance of the full risk assessment process. The effects of significant changes should be evaluated, and the review should be based on information collected from visits, inspections on and off the site, and from other sources.

Notwithstanding the above, it might happen that in the course of ongoing monitoring, the Supervisory Authority receives new, significant information which may affect the

⁶ Compliance with the stipulations of CRD must be examined not only in the case of advanced methods

institution's risk profile, so it calls for a complete review process at the given institution, even if this was not planned in advance.

3 SREP Grades

The principle of proportionality is a key consideration in the ICAAP review. The extent of supervisory expectations regarding the internal capital requirement calculation depends on the following attributes of the institution:

- type,
- size,
- complexity of operation,
- and, naturally, the risk profile of the activities.

Proportionality is a relative term that is a result of above mentioned factors. It has to be noted that the realisation of the principle of proportionality refers to all institutions falling under the scope of the CRD i.e., the depth of the supervisory review process and the dialogue with the institution will be different according the above factors. Based on the principle of proportionality, the SREP is to be used differently against institutions representing different risks.

From the aspect of intensity, three levels of SREP have been defined. However, according to the principle of proportionality, these three levels are not strictly separated, and they can be applied gradually, according to the activity and the complexity of the institution, and there may be overlaps and combinations of tools for certain institutions.

Simple SREP:

- **institutions:** Institutions of simple activity structure, which do not use an advanced method to measure their risks, they have a low market share, and are not involved in any cross-border activity. Based on the classification of their effects, they fall into the weak (GYH) or below medium (KAH) categories and currently include typically small banks, savings co-operatives and investment firms.
- **tools:** questionnaire for assessing the quality of ICAAP, sometimes consultation with the management, evaluation of collected ICAAP documentation. The expectations are: risk strategy, list and definition of material risks, satisfactory capital plan for the maintenance of capital adequacy, stress tests.

Standard SREP:

- **institutions:** Institutions or groups with a complex activity structure, typically between the two extremes and medium strong effects. Banks, savings co-operatives and investment firms currently classified into the above medium category
- **tools:** Combination of SREP tools depending on the complexity of the activity; from a questionnaire to a thorough on-site inspection. Concentrating on typical and material risks, the dialogue includes on-site visits, too. The ICAAP of the institution is compared to institutions of similar nature: risk strategy, description of major risk types, risk assessment and management, capital targeting, quality of internal control.

Complex SREP:

- **institutions:** Institutions and/or groups with a complex activity structure and with significant market share, typically applying advanced risk measuring tools and having active cross-border activities. Currently the bank groups classified in the strong effect (EH) category fall belong to this group.
- **tools:** Intensive ICAAP-SREP dialogue, typically with multiple site visits, inspections.

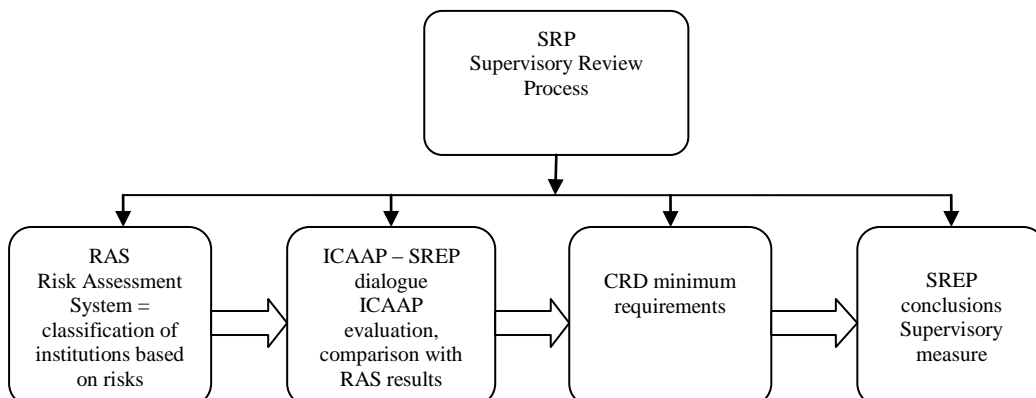
In institutions which are not classified in the strong (EH) or medium strong (KEH) categories but may not be considered small institutions for ICAAP purposes as they use the advanced method and the SREP cannot be simplified into questionnaire processing, the SREP process is similar to the process applied in institutions classified in the strong and medium strong categories. The same relates to those small institutions that do not have a sufficiently transparent ownership structure or where the Supervisory Authority considers it necessary to conduct a standard SREP instead of a simplified process (irrespective of the size or type of the institution) due to their risk profiles (e.g., being members of international groups).

4 The SREP Process

The process of SREP can be divided into the following parts:

1. RAS – assessment of risks and risk controls of institutions
2. ICAAP evaluation – the evaluation of the ICAAP mechanism established by the institution through an ICAAP – SREP dialogue
3. Assessment of compliance with minimum standards set in the CRD
4. Supervisory measure based on the results of the review process

1. Figure: SREP process



4.1 RAS – Risk Assessment System:

HFSA applies a Risk Assessment System built on the basis of the same principles and uniform methodology to all institutions. Our system was developed in line with the stipulations of the CRD pertaining to Pillar 2 and the expectations for RAS stated in CEBS GL03. The risks of institutions are determined on the basis of their effects on the objectives, tasks of the Supervisory Authority, and on the basis of the probability of risks occurring in their operation. The Risk Assessment System consists of the following components:

RAS - elements:

1. *Classification of institutions based on effect*

The Supervisory Authority measures the effect of the supervised institutions based on the size of the institution, the number of consumers having a relationship with it or the size of the client assets managed by the institution, but the effect algorithm may also contain other attributes reflecting supervisory significance, which may vary by sector depending on the specificities of the individual sectors. Consequently, the classification based on effect takes place according to an algorithm established by institution type/sector and the criteria are selected, reviewed and quantified annually.

2. *Classification of institutions by probability*

- a. Institution evaluation - full,
- b. Institution evaluation - simplified,
- c. Based on monitoring (according to the received data supply, the weighted monitoring indicators result in automatic classification).

On the basis of their effect and probability classification, institutions are listed in the effect and probability matrix, and the applicable supervisory tools are defined based on their position in the matrix.

RAS – Grades:

The institution evaluation reflects the riskiness of an institution by evaluating and classifying the risk categories and elements associated with the environment, corporate governance, market presence, business processes and capital risk categories and by establishing a synthesised classification figure.

The evaluation is performed on the basis of the important criteria of the specific institutions reflecting the specificity of their relevant activities, areas, processes and risks. The supervisor selects the criteria used for the assessment of a specific process and decides on its weight compared to other activities, processes of the institution.

The elements of the financial and operational risk categories and their segments are evaluated and classified on the basis of business processes, classifying separately the inherent risks and risk controls.

The input classification levels of inherent risks may be low, moderate, significant or high, while the input classification level of controls may be strong, adequate, weak or inadequate. The aggregated risk category level of financial and operational risks, the

synthesised classification levels (net risk) may be low, moderate, significant or high (or a more sophisticated version thereof).

The aggregate classification reflecting the riskiness of an institution may also be low, moderate, significant or high (or a more sophisticated version thereof).

The RAS results have an impact on the additional capital requirement established during SREP. The RAS is a tool which gives sufficient guidance to a supervisor for establishing and justifying any additional capital requirement. It is used by the supervisor for controlling the risk level of the institution specified in the ICAAP.

The correlation between the risk classifications in RAS and the SREP capital requirement:

- If the rating of the examined risk is „Low” or „Moderate”, there is no need to prescribe additional capital during SREP, unless the evaluation methodology related to a specific risk calls for it.⁷ For example, when the applied method has deficiencies, resulting in insufficient capital size, or if capital is required based on an interest rate risk stress test or country risk regulations etc. In this latter case, additional capital must be required in any risk rating.
- If the rating of the examined risk is „Significant”, the supervisor may consider the requirement of additional capital, the extent of which is defined on the basis of risk assessment, relating to the factors determining the level of inherent risks, or to lack of prudent risk management. The justification for demanding additional capital may consist of the following factors:
 - during the supervisory evaluation, the level of inherent risk is higher than the one identified by the institutional ICAAP. The factors not considered by the institution have to be listed.
 - the evaluation detected risk management deficiencies which require additional capital until they are solved. The deficiencies have to be listed.
- If the rating of the examined risk is „High”, it means that in the given risk category, the institution assumes a „Significant” or „High” inherent risk with „Poor” or „Insufficient” risk control. This necessitates that in this rating, additional capital is to be prescribed in each case, and its extent is defined and justified in the way described above. Prior to the capital requirement used as the final measure, the use of other supervisory measures should also be considered.
- Strategic risk and reputation risk are given a control type rating, so the above are valid as follows:
 - if the strategy and the reputational risks are classified as „Strong” or „Satisfactory”, there is no need to prescribe additional capital;
 - if the strategy and the reputational risks are „Poor”, the prescription of additional capital should be considered, its extent is defined and justified according to the same rules as described for the risk category of risk type;
 - if the strategy and the reputational risks are classified as „insufficient”, the prescription of additional capital should be ordered its extent is defined and justified according to the same rules as described for the risk category of risk type.

⁷ e.g., expectations related to the interest risk of the banking book or the country risk, see ICAAP Guide

If an institution uses an economic capital calculation model, and during the review of the model, the reasonableness test brings good results, and no serious deficiencies were detected by RAS, the review may accept the results of ICAAP, and will not necessarily identify additional capital requirements for the individual risks. (Reasonableness test – if an institution presents a model supported by enough details and justification to the supervisory authority and it leads to reasonable result, the review will take place in a really smooth way.)

Supervisory review process of groups

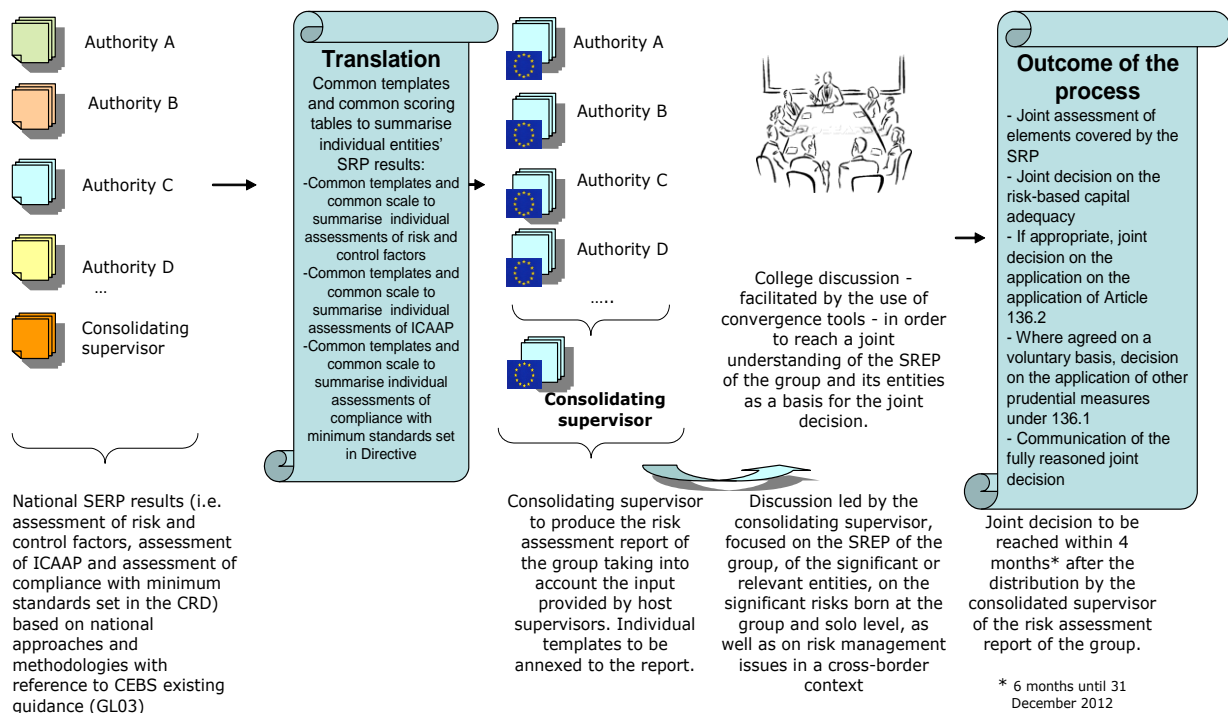
Due to the change of the CRD, effective 2011, banking groups with an EU-based parent institution are subject to joint risk assessment and a joint decision concerning their Pillar 2 capital requirement.

As a joint effort, the supervisory college of the banking group analyse the risks, risk management and capital requirement of the banking group and the relevant members, reveal risks and assess risk controls (at solo, sub-consolidated and consolidated level). Then a joint decision is made on risk-based capital adequacy

The authorities in charge have four months to carry out the SREP of the group⁸. In that timeframe, they must decide if the consolidated solvency capital of the group is adequate in the light of the financial position and risk profile of the group. Any additional capital requirement will be set by the authorities on a consolidated basis or for a specific group member.

The following chart shows the joint risk analysis and decision-making on risk-based capital adequacy to be carried out in the supervisory colleges of banking groups:

⁸ ACI, Article 146



Risk profile (inherent risks and risk control)⁹

The consolidating supervisor and the national supervisors must perform risk analysis on a solo, sub-consolidated and consolidated level (inherent risks, risk management and risk controls). Then they must produce an assessment report in standardized format, provide scores (ratings) for assessed risk types and supply supporting arguments for the rating decisions.

Areas of risk assessment proposed by CEBS:

- summary overview of the institution's/group's risk profile (strengths, weaknesses, major changes in the risk profile)
- financial position
- business and risk strategy, risk appetite/tolerance, corporate and internal governance,
- individual risk factors (inherent and risk control):
 - credit risk,
 - risk transfer through securitization activities,
 - market risk,
 - operational risk,
 - liquidity risk,
 - concentration risk¹⁰
 - interest rate risk (from non-trading activities),
 - other risks

⁹ CEBS guidelines for joint assessment of the elements covered by the supervisory review and evaluation process (SREP) and the joint decision regarding the capital adequacy of cross border groups (GL 39) _Chapter 2

¹⁰ CEBS guidelines on the management of concentration risk under the supervisory review process (GL 31)

Although it is recommended to separate the inherent and risk control of the aforementioned risks upon assessment and rating, a consolidated score can also be applied if it takes into consideration the different risk assessment systems of college members.

Principles recommended by CEBS for *inherent risk rating*:

Score category 1

Low risk of impact on the prudent operation¹¹ of the banking group or institution

Score category 2

Medium-low risk of impact on the prudent operation of the banking group or institution. Nonetheless, a change in the situation could relatively quickly have a significant impact and thus the risk(s) and the processes reflecting weaknesses need to be monitored.

Score category 3

Medium-high risk of impact on the prudent operation of the banking group or institution. The risk management process and risk control of the institution thus requires supervisory attention.

Score category 4

High-risk of impact on the prudent operation of the banking group or institution. The risk management process and risk control of the institution requires heightened supervisory attention.

Score categories to be applied by the HFSA for inherent risks:

- 1- low risk
- 2- moderate
- 3- significant
- 4- high

Principles recommended by CEBS for *rating risk controls*¹²:

Score category 1

A high level of risk management and control. The risk management and control framework is clearly defined and fully compatible with the nature and complexity of the institution's activities.

Score category 2

An acceptable level of risk management and control. The risk management and control framework is adequately defined and sufficiently compatible with the nature and complexity of the institution's activities.

Score category 3

¹¹ According to the CEBS guidelines, prudential operation refers to elements that influence the institution's current and future solvency and profitability, its reputation on the market, its liquidity and the adequacy of its organisation.

¹² CEBS High level principles for Risk Management (CP24)

Risk management and control needs improvement. Risks are insufficiently managed (mitigated) and controlled, leaving too high a residual risk for the institution. The risk management and control framework is poorly defined or insufficiently compatible with the nature and complexity of the institution's activities.

Score category 4

Risk management needs drastic and/or immediate improvement. Risks are not or inadequately managed and poorly controlled. Neither the design nor the operation of the risk management and control framework is compatible with the nature and complexity of the risks conveyed by the institution's activities.

The score categories applied by the HFSA for risk controls:

- 1- strong
- 2- adequate
- 3- weak
- 4- inadequate

The HFSA allows the use of + and – signs to make risk assessment more specific. The RAS followed by the HFSA are set out in the document titled “Handbook for Group Risk Assessment and for filling out the Risk Assessment Template” (definitions, requirements).

Organized, led and structured by the consolidating supervisor, the supervisory colleges of the banking group discuss and jointly assess the risk reports and scores.

As home supervisor, the HFSA elaborated the following risk assessment areas based on CEBS’ recommendation:

- 1) Risk profile, business model, activities, market presence
- 2) Strategy, risk appetite/tolerance
- 3) Corporate and internal governance
- 4) Financial position (profitability and capital)
- 5) Credit risk (including concentration risk)
- 6) Market risk (including interest rate risk)
- 7) Operational risk
- 8) Liquidity risk
- 9) Other risks (e.g. reputation)

Regarding risk elements 1) through 4), host supervisors are requested to provide a net risk score. For elements 5) through 9), we accepted the presentation of only the risk in 2010 but we requested that attempts should be made to perform a combined assessment of risk factors and risk control. This request was fulfilled in the majority of cases. Effective 2011, both risk factor and risk control assessment is mandatory for risk elements 5-9.

In the course of the college dialogue, the members of the supervisory college must perform a joint analysis and assessment and develop a joint opinion regarding the identified risk elements, the quality of risk management and control mechanisms at the banking group and its members. As a result, this approach will highlight the main weaknesses of the banking group’s key risk exposures and internal control processes (summary table).

Where the HFSA is the consolidating supervisor, it provides for the execution of the entire process:

- preparation of the joint risk assessment template¹³ and the completion guide, having them approved by college members,
- elaboration and execution of the risk assessment procedure (e.g. setting deadlines)
 - a. collection of individual risk assessments, presentation and discussion of them at a college meeting
 - b. preparation of the preliminary consolidated risk assessment, presentation and discussion of it at a college meeting, joint evaluation of risk factors and control functions both on a solo and a group basis (summary table)
 - c. approval of the final consolidated risk assessment report and the related action items for the college
 - d. if needed, presentation of risk assessment results to the management of the Banking group

4.2 ICAAP evaluation – assessment of the ICAAP mechanism implemented at the institution through the ICAAP – SREP dialogue

The ICAAP Evaluation Process

The ICAAP guidelines for supervised institutions are available on the Supervisory Authority's website; this document summarises the supervisory expectations applicable to the internal capital adequacy assessment process. The ICAAP must be submitted upon the request of the Supervisory Authority, with prior notification.

The official ICAAP documentation presented to the Supervisory Authority by the institution must always present the methods which were implemented with the approval of the top management.

The data of the documentation must contain the most up-to-date information in order to reach adequate conclusions. (Otherwise, the Supervisory Authority is forced to apply additional conservatism in the establishment of the degree of capitalisation if it cannot have access to updated figures or methods.)

The institution must immediately present, without any delay, information on any significant change taking place in the already submitted documents in the specific year.

The annual review of the SREP¹⁴ is stipulated in the CEBS Guidelines and in Article 145/A g) (5) of the CIFE Act. This, however, does not mean that the Supervisory Authority carries out a comprehensive assessment at each institution annually. The requirement of an annual review of the SREP is fulfilled by the Supervisory Authority

¹³ Common template for the assessment of risk factors and control factors

¹⁴ see footnote 4,

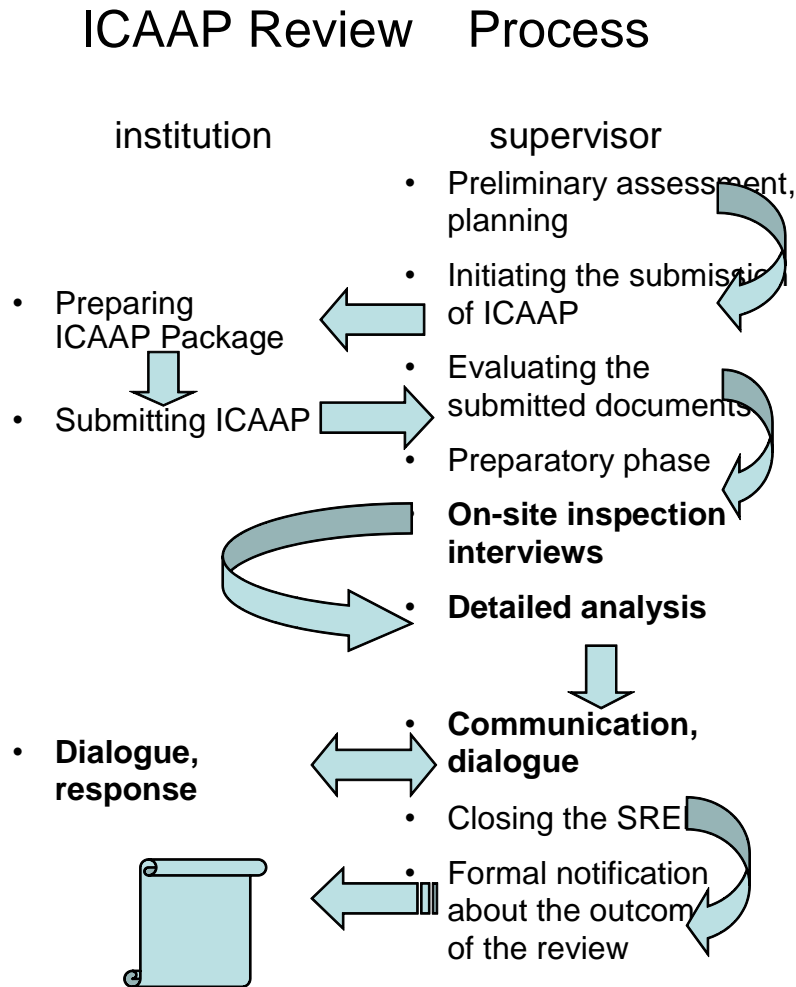
based on the information available about the institution by reviewing the institution's risk position.

The Supervision reviews the ICAAP of institutions and groups using the top-down method focusing on risks while taking into account reasonableness and sufficiency criteria. During this review process, the institutions should provide proof: they are required to justify the correctness of their capital calculation and underpin the applied methodologies and assumptions.

In the case of international groups, the Supervisory Authority pays special attention to the following considerations as especially important in the ICAAP reviews:

- What is the dialogue between the subsidiary and the parent company like, how much the internal capital requirement calculations are used at the subsidiary: is a detailed and thorough knowledge of the centrally used method available at local level, too?
- Are central and local tasks well defined in the use of the internal capital requirement calculation: are the identification, assessment and evaluation of tasks consistent and cover every detail?
- Are the results of the calculation made at group level included in the local decision making, internal control and risk management processes?

Figure 2: ICAAP Review Process



In the case of international groups with an EU parent bank, the consolidating supervisor coordinates the assessment of the group-level ICAAP documentation, methodology, stress testing, capital calculation and the framework of internal governance and controls. ICAAP assessment is carried out in the supervisory college both at group level and at sub-consolidated or solo level¹⁵. The joint ICAAP assessment is based on the completion of the ICAAP template¹⁶ approved by college members and set out in the CEBS recommendation.

Both college member supervisors and the consolidating supervisor review and assess the consolidated, sub-consolidated and solo ICAAP documents and ICAAP processes and submit results in a standardized report to the consolidating supervisor that organizes, leads and guides

¹⁵ Guidelines for joint assessment of the elements covered by the supervisory review and evaluation process (SREP) and the joint decision regarding the capital adequacy of cross border groups (GL 39) – Chapter 3.

¹⁶ Common template for the translation of ICAAP assessments.

the college. Concerning the structure of ICAAP assessment and rating, CEBS provides the following guidelines:

Elements of the ICAAP evaluation process:

- Overall evaluation of the ICAAP prepared by the institution including (where applicable):
- Entities covered by ICAAP scope:
 - organisations, institutions
 - risks
- ICAAP methodologies
- Diversification effects
- Stress testing framework
- ICAAP governance and internal control
- Major deficiencies and observations
- Conclusions and necessary explanations

Criteria for assessing the accuracy and robustness of ICAAP methodologies and processes:

Score category 1

ICAAP Methodologies and processes are of good quality. They make it possible to determine a precise and accurate estimate of internal capital needs both overall and per risk factor.

Score category 2

ICAAP methodologies and processes are of satisfactory quality. They make it possible to determine an estimate of internal capital both overall and per risk factor in a conservative and prudent manner.

Score category 3

ICAAP methodologies and processes are of unsatisfactory quality. They potentially underestimate the internal capital needs both overall and per risk factor.

Score category 4

Methodologies and processes are largely insufficient. They significantly underestimate the internal capital needs both overall and per risk factor.

Organized, led and structured by the consolidating supervisor, the supervisory colleges of the banking group should discuss and jointly assess the following based on the ICAAP reports and scores:

- whether the ICAAP framework, at the group and entity levels, adequately captures all relevant entities and business lines, as well as current and expected material risks and whether it complies with section 123 of the CRD.
- the extent to which processes and methodologies used by the institutions generate reasonable, comprehensive, risk-based, robust and sufficiently precise ICAAP outcomes, both overall and per risk factor (taking into consideration the principle of proportionality).
- when an economic capital model is used (mostly at large international banking groups), the quality and quality and suitability of the methodology related to the different entities of the group, its level of conservatism, the treatment of correlations and diversification

effects and the mechanism (criteria, technique) of capital allocation to business lines or entities.

- the institution's capital planning that is based on stress test¹⁷ results. Special attention should be paid to the scope of the stress testing programme, the shock transmission mechanisms and the consideration of stress testing within the risk management systems (both at the consolidated and relevant entities levels).
- the appropriateness of the banking group's ICAAP from a governance perspective (level of involvement of the management body in the internal capital adequacy assessment process, in the related reporting, controlling and decision-making mechanisms, ordering the frequency of revisions).

In the course of the college dialogue, the members of the supervisory college should develop a joint analysis, assessment and opinion on the ICAAP prepared by the banking group and its entities (summary table). In particular, a joint decision is required on the following:

- major deviations between the ICAAP outcomes and supervisory assessments regarding capital (both at the aggregate and/or entity levels);
- identified main deficiencies in control mechanisms;
- validity of diversification assumptions; and
- identified deficiencies in the modelling approaches that are used by an institution.

If the group applies an economic capital model, college members, under the coordination of the consolidating supervisor, should assess its appropriateness at solo level, including diversification assumptions and the allocation of capital.

ICAAP-SREP Dialogue

The capital adequacy evaluation should be the result of a dialogue between the institution and the Supervisory Authority, i.e. the two processes (internal evaluation and supervisory review) are connected during the dialogue. The objective of the dialogue between the Supervision and the institution is to compare the supervisory expectations with the risks and the methodology considered by the institution in the completion of the ICAAP. The intensity and frequency of the dialogue depends on the complexity of the activity of the given institution, the volume of the activity, and the difference between the capital requirement evaluation of the institution and the Supervisory Authority.

In the course of the ICAAP-SREP dialogue, the Supervisory Authority evaluates the internal capital adequacy evaluation processes of the institution and, considering the financial standing and the prudential problems of the institution, the Supervisory Authority prescribes additional capital or applies other supervisory measures.

Principles of the ICAAP-SREP dialogue

Regarding the ICAAP-SREP dialogue, the CEBS GL 03 4. Chapter stipulates the following principles:

- **The Supervisory Authority should develop a proper methodology for the dialogue with the institution, so that the institution could regularly prove that it has enough capital to cover its risks.**

¹⁷ CEBS revised guidelines on stress testing GL 32

The SREP is based on the dialogue between the Supervisory Authority and the supervised institution, i.e. the dialogue will inform the Supervisor whether the ICAAP of the given institution is satisfactory and is properly structured, whether the significant risk elements were considered, how risks were aggregated, what confidence level the capital calculation refers to, etc., but the ICAAP review does not mean the performance of parallel calculations by the Supervisory Authority. It would be inappropriate for the Supervisor to enter into dialogue with pre-conceived ideas about the capital level, i.e. the Supervisory Authority may not prescribe or “suggest” any expected capital level to an institution or group without performing the examination. The institution should be able to justify that the ICAAP calculation is well-founded, and to explain the differences between the capital required by the supervisor and the result of the internal capital calculation.

- **The structure of the dialogue should be based on the “building block” approach.**

The structure of the dialogue should be based on the “building block” approach:

1. Pillar 1 risks (credit, market and operational risk)
2. Risks not fully covered under Pillar 1 (for example, residual credit risk from risk mitigation techniques, securitisation risk, model risk)
3. Risks to be covered by Pillar 2 (interest rate risk in the banking book, concentration risk etc.)

There are some risks that are best covered by Pillar 2, i.e., for:

Risks not managed properly by Pillar 1 (e.g. large exposure risks);

Risks not considered in Pillar 1 (interest rate risk in the banking book, strategic risk);

And external risks (downturn risk) capital adds-on can be allocated under Pillar 2.

4. External factors (risks originating from the economic and regulatory environment, or from the business, economic performance of the institution)

It is important to stress that the above elements should not be interpreted as resulting in automatic additional capital, but the supervisor should consider each case by comparing the qualitative and quantitative elements.

- **Supervisors should use the dialogue to test and challenge the institution’s ICAAP, and to exchange views in order to reach a better understanding of the processes of the institution and the basis of capital calculation.**

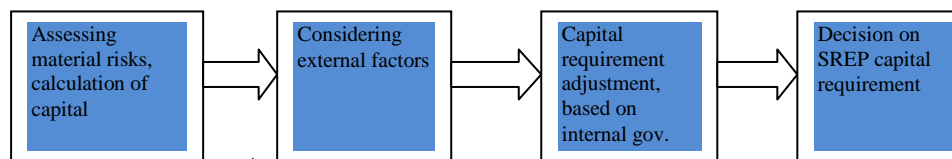
The key point here is to clarify the assumptions and the differences between the regulatory capital calculation (Pillar 1) and the internal capital calculation (Pillar 2), and to learn the correlation and diversification effects. In the course of the dialogue, supervisors may rely on the risk evaluation of the institution, and on the information collected from on-site and out-of-site inspections. In connection with the ICAAP-SREP dialogue, both the Supervisory Authority and the institution itself may modify the result of the capital requirement calculation.

- **The intensity and depth of the dialogue will be determined by the supervisor, according to the risk profile and impact score of the institution.**

The initiator of the ICAAP-SREP dialogue is not the institution, but the Supervisory Authority. The Supervisory Authority will determine the distribution of the available resources, i.e. the intensity and the depth of the dialogue with the given institution. The dialogue with large and more sophisticated institutions and groups is more tailored to fit their particular needs, while at the smaller institutions, standard methods may be used (proportionality).

Steps of the ICAAP-SREP dialogue

Figure 3: Steps of the ICAAP-SREP dialogue



Step I: Assessing material risks

The list of risks in the ICAAP Guidelines cannot be considered absolute or complete. Since each institution creates their own ICAAP, they have the opportunity to develop a risk structure aligned to their own characteristics. They may, therefore, define risks not named in the ICAAP guidance separately; create definitions for the individual risks. It must be ensured that the ICAAP covers all material risks, the risk structure and the provided definitions are justified and acceptable for the Supervisory Authority.

During the planning of the SREP, the starting point is the risk structure developed by the institution; not all risk types should necessarily be considered in the risk review, only the significant, material risks of the institution should be taken into account.

During the SREP process, the adequacy of the **risks covered in Pillar I.** (credit risk, market risk, operational risk), **risks not fully covered under Pillar I.** (residual risk, securitisation risk, model risk) and the **risks covered under Pillar II.** (concentration risk, interest rate risk of the banking book, liquidity risk, country risk, reputation risk, strategic risk) must be assessed.

During the SREP review, when advanced methods are used, it has to be ensured that the key parameters of the authorised models are still appropriate and lead to an adequate capital calculation and whether or not the institutions have the permission of the Supervisory Authority to use them.

Within the framework of assessment of those risks (including also reputation risks) which are managed by the institution with internal processes, the Supervisory Authority examines whether or not the procedures used by the institution for managing the specific risks were presented in the ICAAP and whether they give further guidance for the institution's self assessment, where assumingly these risks are also reviewed.

The data supplied by the institution are entered into the Pillar 1. minimum regulatory capital requirement and ICAAP capital requirement columns of the SREP review form. The Pillar 2 capital requirement column established as a result of the ICAAP-SREP dialogue contains the capital amount deemed necessary as follows for each risk within the framework of the SREP review:

- When Pillar 1+ method is used: The higher of the Pillar 1. (Pillar 1. minimum regulatory capital requirement) and the ICAAP capital requirement (column 2), adjusted by the figure calculated during the SREP.
- When an internal model is applied, the procedure should be carried out as described in the chapter dedicated to the diversification effect.
- The available data should be comparable, i.e. when models are used, the ICAAP calculation should be made using the confidence level applied under Pillar 1 (or the results received at another confidence level should be „recalculated” for this confidence level). This varies by risk; for credit risk the IRB confidence level is 99.90%.

If it is found during the supervisory review that the institution's minimum capital requirement calculated by the applied methods is not sufficient to cover the risks, the standard method underestimates the risks, the Supervisory Authority may prescribe

additional capital need duly justified in the ICAAP-SREP dialogue under Pillar 2. The rate of risks undertaken, the quality of the management of the risk in question and the experienced deficiencies in risk management are all taken into account in the assessment. Any risk which is a risk in the institution's ICAAP, but is not defined in these guidelines, yet may be classified a material risk, must be managed under the title of **other material risks**.

Step 2: Considering external factors

After evaluating the key risks and specifying the capital coverage, the Supervisory Authority reviews

- the methods and outcome of the institution's stress tests,
- the institution's profit generating capacity,
- the adequacy of the capital planning mechanisms and the actual capital plan.

The assessment aims at establishing a dynamic approach instead of the former static one regarding capital requirement, ensuring that the institution – in case of severe, radical changes occur in the external environment – could have the necessary funds for their safe operation in the foreseeable future, taking into account their future capital needs generated through their own business growth and ability to produce earnings.

Stress tests¹⁸

Stress tests are considered in the calculation of the required capital and in the assessment of external factors so that the institution could have the necessary capital not only for the current risk level, but an appropriate capital level could be guaranteed in the long run, should the risk level significantly change due to unexpected macro-economic events and a negative change in the economic cycle.

Stress tests form a part of the capital management: an internal instrument for the institution to plan their capital need and keep it on the desired level based on the results, as well as an important instrument for understanding the risk profile.

There is no correct stress test process or methodology rule that could be applied to all institutions. This is determined based on the complexity of institution and their activities (size, diversification, sophistication etc.).

In practice, stress tests express the institution's sensibility to exceptional, but possible events expressed in numerical figures. The outcome of the stress tests should be taken into account by the institution as follows:

- It should be considered in the capital planning and integrated in the 3-5 year capital target. Therefore such stress tests play an important role in the creation of the Pillar 2 capital requirement, and the supervisor should check whether the outcome of the stress tests are presented correctly in the ICAAP calculations, since the supervisory capital requirement should include a coverage for potential problems that may arise in the future.
- If the outcome of the stress tests indicates an increase in risks that cannot be undertaken in the future, and cannot be covered appropriately, the management should take the necessary actions to adjust the risk structure. This may involve strategic, business corrections, which may affect the product range, the balance sheet structure, the activities performed etc.

¹⁸ ICAAP expectations regarding stress tests and the related legal references are included in the ICAAP Guidelines, chapter IV. Further guidance is found in CEBS GL12: Technical aspects of stress testing under the supervisory review process

Stress tests normally fall into 2 general categories:

- scenario tests (a number of events have an impact on various risk factors);
- sensibility tests (generally less complex; an event usually has an impact only on the given risk).

Institutions carrying out complex activities and applying advanced internal capital requirement calculation methods should use both the scenario and the sensibility tests or a combination thereof.

The most important steps in order to perform stress tests are as follows:

- identifying risk elements on which stress tests focus,
- level of stress tests (at a consolidated, centralised level; at an individual group member's level)
- specifying the frequency and time horizon of stress testing (ad hoc stress tests may be required by the Supervisory Authority for the assessment of risk impacts which could have similar impacts in a given group of institutions)
- quality and source of data, level of IT support (for AMA and IRB validation these should comply with the rules for introduction)
- communicating the outcome of the stress tests (frequency of reports, management levels)
- taking the necessary steps, intervening (documenting the decision regarding intervention or non-intervention),
- for stress tests the following should be documented: specifying the exposure examined through stress testing (scope); summaries leading to the performance of stress tests; clearly specifying responsibilities from the performance of such tests to the implementation of the necessary measures; obligation related to reporting the result of the stress tests within the institution; type of necessary measures, actions.
- revising and adjusting the institution's stress testing methods.

The institutions are required to carry out stress tests for each significant material risk (macroeconomic and significant risk categories: credit, market, liquidity, operational risk).

Criteria to be taken into account when the appropriateness of the stress tests is evaluated:

- Reliable, good quality data.
- Appropriately long time horizon.
- Consideration of illiquidity and the lack of other market instruments in relation to a crisis.
- Management of aggregation problems.
- Management of correlation problems – in special circumstances the behaviour of correlations changes.
- Strong commitment of top management – they are aware of the outcome of the stress tests, take the necessary corrective strategic or business measures, – if the management does not perform corrections, the SREP requires the prescription of supplementary capital need.
- Appropriate communication of results.

- Appropriateness of scenarios, proper development thereof.
- Necessity of performing stress tests at group level.
- Should be performed at least annually for significant risks (credit, market, operational risks).
- Principle of proportionality: the applied stress tests reflect the scale and complexity of the institution.
- The outcome of stress tests to be performed under Pillar 1 should be considered (pro-cyclical nature of IRB).

It is essential that the institution could prove, in a comprehensive manner, that they are able to fulfil their obligations even in case of recession.

Supervisory Stress Tests

If the Supervisory Authority performs stress tests according to its own methodology, the institutions requested to take part in it must perform the calculations requested by the Supervisory Authority for such purposes and present the requested data within the required deadline. The Supervisory Authority considers participation in the supervisory stress tests part of the institutions' stress testing obligations and the evaluation of the institution's co-operation is part of the SREP process. The institution must continue to perform the stress tests for any other risks that are deemed important by the institution and must present the results of such tests during the SREP process.

Profitability and capital planning

Capital planning plays an important role within the ICAAP process, since the institution should possess the necessary capital to cover their risks not only at a given moment, but on a foreseeable time horizon. For this reason, they have to review their own business plans, consider their growth needs, their ability to produce income in order to generate internal capital, and the viability of the business model, should a recession occur. In order to guarantee cover for future capital needs, the capital plan should include ideas about the possible sources, which should be well-established and acceptable for the supervisor. The institution is expected to consider the future 3-5 years depending on their size and activities. Pillar 2 risks should also be covered in the capital plan.

If the profitability and capital planning are classified as inadequate or poor, this indicates that

- the institution cannot provide for the necessary internal capital generation in order to maintain a secure capital level in the future, or even generates losses, which erodes the capital;
- the institution's capital planning procedures are not adequately developed, which endangers the maintenance of the capital level;
- the presented capital plan is not convincing (the planned methods for involving funds are not viable, the institution's ability to raise funds is weak, internal capital generation is not probable etc.), and it is not acceptable with regard to the maintenance of a secure capital level in the future.

If the profitability and capital planning are classified as inadequate additional capital requirement may be considered, but if they are classified as poor, it is advisable to require additional capital during the SREP.

If capital planning and/or profitability are classified as strong or adequate, it is not necessary to prescribe additional capital requirement;
(When capital loss occurs, the relevant provision of Act on Credit Institutions and Financial Enterprises shall apply.)

Taking the outcome of the stress tests into account in the capital planning

In the capital plan, the outcome of the stress tests should be taken into account when determining the necessary future capital and the planned capital should be at a level so that it could provide sufficient coverage even in case of recession.

In the second step, after reviewing the stress tests and the capital plan, the supervisory review may establish additional capital requirement if in the ICAAP the institution did not take into account the capital need indicated by stress tests and/or capital planning or these procedures do not satisfy the Supervisory Authority's expectations. The additional capital requirement is to be calculated based on the outcome of the stress tests and the capital planning.

Review of capital adequacy at international groups

In the examination of the capital adequacy, the Supervisory Authority considers the following points at subsidiary level:

- Is enough attention paid in the capital adequacy calculation to revealing local special risks? At the consolidated level of the EU-level parent company and at the consolidated level of the domestic parent company the (significant) material risks may differ.
- Are the applied stress tests and sensitivity analysis properly adopted, do they consider the economic environment of the given country,
- Is capital size adequate to local business activities; is the capital proportionate to the risk limits and exposures?
- How are inter-group transactions evaluated and the risks undertaken?
- What is the method used for capital allocation within the group: is it with a simple method or is the diversification effect¹⁹ also considered in capital allocation?
- At local level, are the diversification effects acceptable in the risk aggregation level? In general cases, the Supervisory Authority does not accept the realisation of the diversification impact.
- Possibility of capital transfer within the group: how can the given institution get the required capital in a stressed financial position?

If the allocated capital is inadequate, the Supervisory Authority as a „host” authority may prescribe additional capital requirement according to Pillar 2, and may initiate other actions, too²⁰.

¹⁹ SREP Diversification Chapter

²⁰ SREP Supervisory Actions chapter

Step 3: Adjusting the capital requirement based on the evaluation of the internal governance

Since under Pillar 2 it is required that the institution itself creates the capital adequacy procedures, and the institution's management is responsible for guaranteeing an adequate capital level the evaluation of the internal governance is a significant element of the SREP. If the Supervisory Authority revealed substantial deficiencies in this field, the SREP results in higher capital requirement.

The relevant chapters of the CRD, the Act on Credit Institutions and Financial Enterprises and CEBS GL 10 and GL 03 contain detailed rules for the internal governance of institutions operating under CRD and the Act on Credit Institutions and Financial Enterprises. CEBS CP24 contains further guidelines for risk management, while CP23 and CP42 provide further guidance on remuneration and recommends them for review and control to supervised institutions in their ICAAP and to supervisory authorities in their supervisory reviews.

These rules are also discussed in detail by the ICAAP Guidelines published for the supervised institutions giving guidance on the expectations against a properly functioning internal governance system.

If *the Internal governance and/or the Internal control systems is/are* rated as "strong" or "adequate", it is not necessary to prescribe additional capital requirement.

If *the Internal governance and/or the Internal control systems is/are* rated as „poor' or „inadequate', additional capital requirement must be prescribed in the SREP; the same rules apply to the specification and justification of such capital requirement as in the case of risk type class risk categories.

Internal governance

Definition of the role and responsibilities and powers of the board of directors and the executive management

One of the most important requirements of the internal governance is that the responsibilities and powers must be clearly specified within the decision-making procedures of the institutions.

The board of directors and the executive management can delegate some of their responsibilities and powers to the risk committees functioning within the institution. The establishment of these committees can foster efficient operation and also the better understanding of the applied systems.

Even if certain functions are delegated, the board of directors and the executive management are not exempted from the responsibility, since they are responsible for the development and introduction of the IRB method and for the whole risk assumption process according to Article 13/C of the CIFE Act.

The institution's risk assessment procedures must be approved by the board of directors, or the Committee having the powers delegated by the board of directors, and the executive management. These bodies must have adequate knowledge so as to understand the risk controls of the institution, and the related management reports.

In relation to the internal governance, the risk control analysis must also extend to the following:

- the relationship between the risk management strategies and procedures and the internal control system,

- control functions within the organisation,
- definition of acceptable risk (using the IRB result, in order to map the credit risk profile of the institution).

Internal reports

The analysis of the institution's risk profile must be an important part of the internal reporting system.

These reports must be forwarded not only to the board of directors and the executive management, but also to those entities that are responsible for risk assumption and monitoring.

The frequency and depth of reporting shall be approved by the board of directors and the executive management.

In addition, the content and frequency of reporting must also depend of the risk level and on the recipients of the reports. The CRD specifies the minimum requirements for the reports (Annex VII. Part 4, Article 126.)

Remuneration Policy

According to the relevant²¹ requirements of CRD III and the Supervisory Authority pertaining, the remuneration policy must harmonize with the business strategy, values and long-term interests of the credit institution. Furthermore, the remuneration policy must harmonize with the requirement of efficient and effective risk management and should foster the application thereof. At the same time, it must not encourage the assumption of risks that exceed the risk tolerance of the institution.

When setting and applying remuneration policies for employees whose professional performance has a profound impact on the institution's risk profile, institutions must fulfil the relevant HFSA recommendation and the CRD guidelines in a manner suitable for their size, organization and the nature, scope and complexity of their activities.

The supervisory review also extends to the remuneration system of the financial institution and the Supervisory Authority intervenes if the remuneration policy would result in any excessive risk assumption that is not in line with the company's long-term interests. The supervisory measures include the prescription of additional capital requirement under Pillar 2 (if the supervised institution does not take adequate action).

The supervisory colleges discuss remuneration issues and assess the harmonized compliance of remuneration policies and practices with home/host supervisory requirements. The topics reviewed when assessing remuneration policies are as follows:

- remuneration policy at group level;
- different remuneration regulations per jurisdiction;
- influence of the parent bank regarding the application and development of remuneration policies at subsidiaries;

²¹ Recommendation No. 1/2010 of the Chairman of the Hungarian Financial Supervisory Authority on the application of the remuneration policy (prepared on the basis of CEBS guidelines) will be revised soon in order to include the provisions of the CRD III guideline and the requirements of the CEBS Guidelines on Remuneration Policies and Practices (CP42) that is based on the former. The guidelines address several aspects of remuneration which are specified as new elements in CRD III regulations and provide detailed and practical guidance regarding existing guidelines. This section outlines CRD III requirements which also serve as a basis for domestic regulations

- responsibility of subsidiaries regarding remuneration policies and practices
- relationship between the group remuneration committee (if established) and the remuneration committees of subsidiaries
- compliance with remuneration principles regarding all institutions of the group
- application of the remuneration policy in the management matrix organization.

Risk management:

The role, function, organizational structure, mandate, reporting process and hierarchy of Risk control must be established in accordance with the ICAAP guidelines and the recommendations referenced therein.

The independent risk control unit(s) must ensure that each element of the risk measurement and assessment process (evaluation, parameter estimation, data collection and review) functions appropriately. The evaluation of the risk management system and the main criteria thereof will be elaborated in detail later on herein.

The role of internal control

The internal control unit must review the control system of the institution, including especially the rating systems and the parameter assessments. Therefore, the unit must have adequate information on the rating systems, as well as those procedures and processes that are related to parameter assessment.

Within the framework of the review of the control mechanisms, the internal control unit must inspect the quality and depth of Risk control, as well as the scope of their activities. In addition, it must also inspect the adequacy of the IT infrastructure, data protection and data management. In case the institution uses a statistical model, the internal control unit must test the procedures of data entry.

The internal control unit must prepare a report for the Board of Directors and the executive management at least once a year and state whether the institution complies with the requirements, which stipulated by the CRD and the Act on Credit Institutions and Financial Enterprises

Independence and conflict of interest rules during the rating procedures

Risk management depends on the organisational structure of the institution, and the procedures inherent in the business processes.

Although the control procedures may differ from institution to institution, or from portfolio to portfolio, they usually include a “submitter” and an “approver”, whose tasks and responsibilities may be different. (These tasks and responsibilities may be different in the different portfolios.)

A few examples for the most general situations:

- rating is prepared by the relationship manager, (even in this case the counter-signature of an internal risk manager, independent from the acquisition, is required)
- rating by the model, the end result of which cannot be overridden by the sales representative,
- rating by an independent risk manager or risk assessment committee,
- other rating.

Reliance on the external auditor’s work during the review process

In several cases, the CRD and the Act on Credit Institutions and Financial Enterprises define tasks that must be performed by an independent unit/person. (See GL 10., 3.6.5., and Statement 6 of Part 3 in Annex X to the CRD, according to which the operational risk management procedures and measuring system must be inspected by an internal or external auditor.)

Control system for operational risk

During the development of the control system of the operational risks the institutions must pay attention to the difference from financial risks, according to which operational risks can be found in each activity of the institution or organisation, and such risks manifest themselves in different types of events.

In accordance with this, risk prevention and identification, response measures and actions designed to offset the damage require the combined application of centralised specific measures and local procedures in the individual work processes (such as technical and IT security solutions, process-integrated controls suitable for the different activities, BCPs and DRPs for the management of extraordinary situations, prompt action plans, insurances providing preliminary security for the subsequent recovery of potential damage, and the related internal regulations).

At the same time, Internal Governance issues related to the operational risks must be handled similarly to the financial (credit and market) risks²²:

- at the level of corporate management the risk tolerance ability (the extent and scope of tolerable losses) must be defined,
- the strategy and procedure for the assessment, management and monitoring of the operational risks must be developed,
- in line with this, the institution must establish the organisation be fitting the complexity and range of the institution's activity (independent risk control unit, BLORMs /business line operational risk manager/, a possible separate compliance function), as well as the tasks, scopes and responsibilities,
- the method of operation of the reporting system ensuring the flow of information must be defined (content elements ensuring information supply to the management /event data/losses, self-assessment/, applied technique, frequency/, and the system of related management measures – in relation to activities performed within the institution, as well as activities performed in the framework of outsourcing),
- the procedure applied for the calculation of the operational risk capital requirement must be determined (selection of the method /BIA, TSA, ASA, AMA/, and the system of references to be taken into account during the current calculations), which must be recorded in the institution's ICAAP,
- the adequacy of the entire system must be evaluated and regularly revised within the framework of the independent (internal and/or external) audit.

The HFSA shall take into consideration the adequacy of all these elements in the course of evaluating the capital requirement calculation, the SREP.

²² On 12 October 2010, CEBS issued guideline GL 35 on the management of operational risks arising in relation to investment services which the HFSA will adopt in its Recommendations presenting best practices by 30 June 2011.

*Evaluation of the risk management system, the major aspects of evaluation*²³

The supervisors must make sure that the institution has a comprehensive risk management process in place which identifies, assesses and checks all material risks, and assesses the entire capital requirement in accordance with the risk profile of the institution. This system must be proportionate to the size and complexity of the institution.

Basic conditions:

1. Each institution or group of institutions must possess a comprehensive risk management policy and regulation that are suitable for risk identification, assessment, control and mitigation. The supervisors examine whether these processes are proportionate to the size and complexity of the institution; from time to time, they track changes in the institution's risk profile and in market processes. In case the supervisors find the risk management process inadequate, they may order the institution to reinforce the process.
2. The inspectors must make sure that the institution/group of institutions has proper risk management strategy and risk appetite which have been approved by the Board of Directors/management body, too. The Board of Directors/management body is responsible for the further development of this strategy, for setting adequate limits and for making sure that the institution's Executive Management takes the necessary steps for checking and controlling the risks, in line with the expectations laid down in the strategy.
3. In the course of the SREP, it is verified whether all risks, business processes and group members are covered by the organization and responsibilities of risk control. It is also reviewed whether the risk strategy, risk appetite and responsibilities are communicated²⁴ within the organization and in what form (rules and process of communication) and whether everyone is aware of his/her responsibilities regarding the identification and reporting of risks and if the risk is financial in nature or not (reputation risk).
4. The supervisory review of the risk strategy, risk appetite and risk tolerance set out in the institution's ICAAP includes the review of whether these items have been documented at the institution and if they cover all risks assumed by the institution (e.g. off-balance sheet activities). Risk appetite and tolerance can be expressed in different forms in the ICAAP.
5. In the course of the supervisory review, supervisors check whether the institution's minimum/maximum requirements regarding either the quantitative (KRI) or the qualitative (target customer base, new product launch) levels of risk appetite are realistic (in the light of the institution's size, business activity, customer base, market and environmental factors).
6. The review also addresses the frequency and form (reporting process) of checks performed by the institution's management body to verify the fulfilment of the risk strategy, the quantitative and qualitative elements of risk appetite and risk tolerance, and whether a process is in place for interfering and making adjustments if necessary (in case of deterioration)

²³ Core principles methodology, October/2006, Basel Committee on Banking Supervision/ Bank for International Settlements

7. The inspectors make sure that the members of Board of Directors and the Executive Management are aware of the risks assumed by the institution, and the relationship between these risks and the capital adequacy of the institution. Executive Management must ensure that the risk management regulations and processes are in line with the risk profile and business plan of the institution, and are efficiently incorporated into the institutional processes. This supervisory requirement also means that Executive Management must regularly review the received risk management reports and supervisors will also check whether the necessary actions have been taken.
8. The institution must have an internal capital adequacy assessment process (ICAAP) suitable for its risk profile. The characteristics of the procedure and the depth of the ICAAP process must be proportionate to the size of the institution, as well as the complexity of its organisation and its business strategy.
9. As part of their risk management, institutions use risk models²⁵ in various areas. When applying these models, institutions must keep in mind that the models are only one element of the risk management system and they only support the accomplishment of risk management objectives in combination with expert estimates and decisions. When making risk decisions and stress tests, the decision maker should stay away from relying exclusively on supporting quantitative information and the metric outputs of model results, a qualitative approach is also necessary (e.g. expert opinion, estimate). If the group of institutions applies a model for the measurement of the different risk elements, the supervisor must check whether the institution regularly checks, tests and performs the qualitative verification of the model and the systems in an independent manner.
10. The supervisor checks whether the institution/group of institutions possesses an adequate IT system for measuring and assessing the size, quality and content of the accounts receivables, and for preparing the reports. The reports shall be delivered to the board of directors and the executive management on a regular basis, and shall reflect the risk profile and the capital requirement of the institution.
11. The institution must have rules and process descriptions in place for the launch of new products/markets/business lines²⁶ that contain regulations for the launch, approval, pricing, back office and IT processes of the product. Risk management must participate in both the approval and the monitoring (roll-out) process. During the SREP, the supervisor checks the existence of these rules and also compliance with them.
12. The Supervisory Authority expects larger and more complex institutions to set up a separate organisational unit (function) responsible for the exploration, monitoring, management and mitigation of risks. The supervisor shall ascertain that these organisational units are regularly re-viewed by the internal auditor.
13. Main criteria for the supervisory review of the risk management organization:
 - position of the organization in the institution's hierarchy,
 - structure of the organization (necessary segmentation),
 - responsibilities (if all risks are covered),

²⁵ CEBS CP24 High level principles for risk management

²⁶ CEBS CP24 High level principles for risk management

- direction (Board of Directors, executive management, CRO²⁷, Audit Committee, Credit Committee),
- independence (subordination, superiority)
- decision-making hierarchy, mandates (right of veto, regulations for disagreement),
- risk reporting system
- number of staff and professional competence of the risk management organization,
- remuneration system,
- level of IT support available for the risk management organization,
- regulation of control by internal audit, process,
- regulation of outsourced sub-processes and processes, monitoring within the organization,

In the case of group leader or group member institutions, the supervisory review should extend beyond the risk management organization of solo institutions and also check the group-level direction of risk management (with a view to the criteria described above).

14. The supervisor checks whether the institution/group of institutions possesses risk, monitoring and control functions that are clearly distinct from the organisational, business unit that undertakes the risks. The supervisor also checks the hierarchy of these control units in terms of reporting obligations.
15. The institution must possess a strict, forward-looking stress-testing system that presents the possible impacts of the potential, unexpected market changes and events on the institution.
16. The institutions/groups of institutions must also possess regulations and processes suitable for the assessment of other material (reputation, strategic) risks.

Step 4: Determination of the SREP capital requirement

In the case of banking groups with an EU parent institution, the competent supervisors participating in the supervisory college shall make a joint decision on the adequacy of the consolidated solvency capital of the group in the light of the group's financial position and risk profile. If an additional capital requirement is set, the extent thereof will be decided on by the college either on a consolidated or on a solo institution basis²⁸.

The members of the college shall fill in the CEBS-elaborated summary table²⁹ for assessing the risk-based capital requirement of the institution or group, provide scores for each risk element and then discuss the scores in the framework of the college. Under the coordination of the consolidating supervisor, college members compare the risk assessment and the results of the ICAAP review and discuss recognizable diversification benefits. Finally, both at solo and group level, college members compare the solvency

²⁷ CEBS CP 24: High level Principles for Risk Management

²⁸ Guidelines for joint assessment of the elements covered by the supervisory review and evaluation process (SREP) and the joint decision regarding the capital adequacy of cross border groups (GL 39) – Chapter 4.

²⁹ Common template to report the preliminary individual results of the risk based capital requirements

capital requirement to cover risks to available solvency capital elements, taking into consideration the restrictions concerning capital transfer within the group.

When calculating the capital requirement, college members may require institutions or groups to put in place specific capital buffers or targets taking into consideration the outcomes of stress tests.

When setting a solvency capital requirement, college members should understand the drivers behind the differences between the internal capital estimates and regulatory capital requirements. Similarly, college members should develop a common stand regarding the acceptance and assessment of internal capital instruments that are different from Pillar 1.

The last step in the process is a joint decision to be made by college members based on the summary table³⁰ on the adequacy of the group's consolidated solvency capital with respect to its financial position and risk profile. If an additional capital requirement is necessary, college members decide on its extent either on a solo institution or on a consolidated basis. The additional capital requirement is set as a percentage of the regulatory minimum.

Although the joint decision does not need to set out supervisory measures beyond specifying the capital requirement, it may include additional supervisory measures and requirements provided all members of the supervisory college agree on them.

Available own funds

As it is indicated in the ICAAP Guidelines, in Pillar 2 it is possible to differ from the capital notion of Pillar 1 in relation to the capital elements that can be taken into account and the method of asset valuation.

In relation to the methods, the Supervisory Authority does not explicitly prescribe (support), or ban any unique method, however, it is required that the applied methods be prudent and should not contradict the generally approved principles and methods.

In case an institution uses the possibility of deviation, it must provide detailed and thorough documentation about the selected solutions and the deviations from Pillar 1, and it must thoroughly explain the advantages of the chosen solution.

From the prudential aspect, the elements of own funds must meet the following general criteria:

- they must be regarded as a permanent source;
- they must be usable for the coverage of losses without any limitation, either during operation (going concern), or in a potential liquidation process;
- they must be stable.

The concept of capital and profit as used in accounting often fails to satisfy some of these criteria. However, the supervised institution is allowed to involve new cover elements to meet its capital requirement within the framework of Pillar 2.

The institution must be able to explain the particular tools it uses for meeting its capital requirement. For the relevant inspection, the Supervisory Authority starts out from the following principles, which are also used in accounting:

³⁰ Summary information risk based capital-adequacy of XY Group. See GL 39, table 11

- the value of the asset can be measured in a reliable manner;
- the realisation of the individual assets must be probable (even if an unexpected loss is incurred)³¹.

Based on the above, among others, the following elements can be regarded suitable for meeting the capital requirement:

- unrealised gains of trading books;
- subordinated loan capital that has not been taken into account from the regulatory point of view, etc.

However, the above capital elements do not provide coverage for all types of risks. The institutions must document and explain what liabilities are used for the coverage of which risk(s).

In relation to the allocation criterion, the Supervisory Authority first of all considers the time period of the controllability (liquidation) of the inherent risk, and expects that this should be in line with the expected changes in the value of the capital element. This means that the principle of durability used in Pillar 1 appears here, too; however, its extent depends on the type of the assumed risk. This means that unrealised profit (e.g. unrealised gains in the trading book) cannot be accepted as coverage for credit risks, for example.

Own funds requirement

After the assessment of the capital required for covering the individual risk types, the supervised institutions must aggregate the risks according to the ICAAP Guidelines.

In case aggregation is not a simple summation, but to a certain extent it takes into account the diversification effects, too, the method must be documented in detail and in an understandable manner³². The selected method must be thoroughly justified and it must be proved with strong arguments that the capital needs for the coverage of each, and that the assessment of the full capital requirement is sufficiently conservative. In the case of non-modelled risks any diversification effect can be taken into account only on the basis of very convincing justification.

Within the framework of the ICAAP, the institution determines the security level for which it intends to have capital.³³ The HFSA inspects whether the selected security level is in harmony with the institution's risk-taking appetite and capital planning. Within this, the HFSA inspects how the institution can neutralise the effect of a possible capital loss.

In case this security level is different from the one applied in Pillar 1, (market risk 99%, other risks 99.9%), the institution must (in accordance with the ICAAP Guidelines) show the size of economic capital it deems necessary at the security level complying with Pillar 1, (and applying the capital concept of Pillar 1. The basis for comparison with the capital available in Pillar 1 shall be either the Pillar 2 capital, defined above, or the Pillar 1 capital requirement, whichever is larger.

In compliance with the ICAAP Guidelines, the Supervisory Authority prescribes the determination of the economic capital requirement for a period of one year. The institution may deviate from this requirement provided it can give an adequate

³¹ Practically, this means that future credit revenues cannot be accepted as coverage for lending losses.

³² The principle of methodological neutrality described above is valid here, too, i.e. the Supervisory Authority does not explicitly prescribe (support) a unique method, however it requires that the applied solutions should be prudent, and should not contradict generally accepted principles and methods.

³³ Naturally, only if the capital requirement calculation of the given risk type is based on an internal model.

explanation. E.g.: in case of market risk, if it can prove that it is highly probable that the actual holding period is shorter than one year,³⁴ and adequate control and management procedures are launched in order to avoid further losses.

Additional capital requirement

In case serious concern arises as per the sufficiency of capital determined above for risk coverage, the HFSA may – upon consultation with the supervised institution – prescribe additional capital requirement. The additional capital requirement is defined during the SREP steps described in detail above and must be documented on the SREP Review Form. In summary, the typical cases of additional capital requirements are the following:

- strategic risks that are not properly reflected in the capital calculations: e.g. excessively fast growth, too aggressive market acquisition, fast expansion abroad (acquisitions, foundations);
- lack of necessary experience (newly established company, significantly renewed management, etc.);
- major deficiencies in the risk management system (including the inadequate monitoring and validation of the applied models);
- major deficiencies in the internal governance;
- lack of sufficient conservatism in capital calculation (e.g. too optimistic assumptions, insufficient use of conservative overcharges, inadequate consideration of the stress test results);
- application of disputable, insufficiently justified methods in the capital requirement calculations;
- actually occurred losses.

The HFSA defines the additional capital requirement as a percentage of Pillar 1, either on the basis of the total capital requirement in Pillar 1, or on the basis of the capital requirement of the individual risks or affected portfolios, depending on the type of deficiency. The additional capital requirement defined as a percentage means that the capital requirement in Pillar 2 must be dynamic, and it must be continuously complied with under the next review process. The institution may also request the interim review of the SREP based on sufficient reasoning.

Capital allocation

It is not a mandatory element of Pillar 2, yet it is a rather widely used solution at larger banks that apply a developed measurement and incentive system that the full capital requirement described above is broken down to organisational units and/or activities, usually for the purpose of performance measurement. The so-called diversification profit is distributed within the framework of this procedure (in case diversification effects were also taken into account in the course of summation).

The HFSA regards capital allocation as a type of control of capital calculation, especially if it is linked to performance measurement. The reason behind this is that it affects direct material interests, wherefore it is not expected to contain excessive distortions.

The allocation procedure itself needs to be more thoroughly inspected if the capital requirement of an institution/group of institutions supervised by the Supervisory Authority accumulates through capital allocation. In this case the supervised

³⁴ In this case the major factor is the liquidity of the market of the financial instrument held.

institution/group of institutions is required by the Supervisory Authority to prove that the distribution among the institutions is fair, and it does not entail unjustifiably low capital requirement for the supervised institution(s).

4.3 CRD minimum requirements

Regarding CRD requirements, the HFSA pays particular attention to compliance in the following areas:

- minimum capital requirement calculation (focusing on the use of risk-mitigation techniques)
- taking of large exposures,
- investment limits,
- corporate governance rules (management bodies, internal regulations, internal audit)
- publication.

Since the annual SREP does not allow the HFSA to carry out an in-depth investigation of these areas on each occasion, compliance with CRD requirements is assessed on the basis of former HFSA measures, on-site investigation findings and regular data provision.

In case a comprehensive review is also performed at an institution in the same year, the HFSA attempts to carry out the review of the internal capital requirement calculation (SREP) within the framework of the detailed investigation. On these occasions, an on-site review is also performed regarding internal capital requirement calculations and compliance with CRD minimum requirements.

The supervisory review of banking groups must also cover compliance with the various types of minimum requirements set out in the CRD. The standardized reports prepared by the national supervisors that review the members of the banking group serve as a basis of the joint decision. The standardized reports assess compliance with the CRD as follows:

Table 8.³⁵ Common template to report assessments of compliance with the CRD requirements Entity:			
Topic	Material deficiencies identified	Measures taken or considered	Comments
Advanced approaches under Pillar 1			
Disclosure requirements			
Major deficiencies and observations	<i>Narrative information</i>		
Conclusions and explanations	<i>Narrative information</i>		

³⁵ “Guidelines for Joint Assessment of the elements covered by the supervisory review and evaluation process (SREP) and the joint decision regarding the capital adequacy of cross border groups” CP 39 Chapter 4.

4.4 SREP conclusions, supervisory measures³⁶

Principles of supervisory measures:

Regarding the **supervisory measures** that can be used in the SREP, the CEBS GL 03 chapter 4 stipulates the following principles.

- **The supervisory actions related to the deficiencies found during the SREP and the ongoing monitoring need to be taken without any delay.**

The Supervisory Authority has an obligation to act if the supervisory review and assessment show that the credit institution has inadequate own funds to cover its risk profile, or its internal control or if its risk management and assessment processes do not comply with the legal regulations, which cases can be as indicated below, or the combination thereof.³⁷:

- The Supervisory Authority prescribes the institutions to keep capital higher than the capital requirement defined by Pillar 1, or may oblige the institutions to reach a higher capital level in some other way.³⁸
- The Supervisory Authority may call upon the institution to strengthen the regulations, procedures, strategies and methods related to the internal governance, the risk management system and the internal capital adequacy assessment process.
- The Supervisory Authority may call upon the institution to revise its impairment/provisioning policy, and to create additional provisions/impairment.
- The Supervisory Authority may impose limitations on the activities and operational conditions of the institution.
- The Supervisory Authority may call upon the institution to mitigate its inherent risks related to the activities, the products or the applied systems.

The stipulation of supervisory measures is the end result of completing the full SREP process, provided that they are justified by the examination. The final decision is supported by the dialogue with the institution and by thorough consideration. The prudential tools are selected on the basis of the importance, seriousness and quality of the detected deficiency. Prudential operation may not be substituted by capital, so it is extremely important to assess also the adequacy of the internal procedures, i.e. the consistency and efficiency of internal limits, control procedures, risk management and³⁹ internal governance. Under Pillar 2, the objective of the capital requirement calculation is not only that the institution should create additional capital, but also to encourage institutions to apply more deliberate and efficient risk management techniques to assess, measure and manage their risks and to make sure that they are built into the process and form a part of the everyday operation of the institution.

- **The supervisory actions related to the detected deficiencies should be immediately communicated to the supervised institution.**

³⁶ CIFE Act, Article 153

³⁷ 2006/48/EC Article 136.

³⁸ The national regulations include a limitation of the additional capital prescribed by the Supervisory Authority (CIFE Act Article 153. Paragraph (2) ((9)).

³⁹ Basle Recommendation, Point 723.

In the decision supporting the supervisory action, the Supervisory Authority should detail the detected deficiencies and their assessment, and should describe in detail the reasons for prescribing additional capital requirement and other supervisory measure. The explanation should include the time frame for remedial actions, too.

5 Closing of SREP

5.1 SREP conclusions

The last step of the supervisory review, subsequent to the review of the RAS (Risk Assessment System), the ICAAP, and compliance with the minimum requirements, is drawing conclusions from the SREP.

The Supervisory Authority may reach the following conclusions after carrying out the SREP:

- The institution's internal capital adequacy assessment process (ICAAP) adequately measures the risks, risk management is performed properly, no deficiencies are identified, and Pillar 1, regulatory capital, and the capital allocated under Pillar 2 provide adequate coverage for the institution's risks. In this case, the Supervisory Authority approves the ICAAP documentation submitted by the institution, and stipulates no further capital requirement (in excess of the capital requirement applied by the institution itself), requests no measures regarding the level of risks and changing the risk management and business management methods.
- The institution's internal capital adequacy assessment process (ICAAP) does not fully satisfy the Supervisory Authority's expectations, deficiencies are identified in the risk management procedure, and Pillar 1, regulatory capital, and the capital allocated under Pillar 2 do not provide adequate coverage for the institution's risks. In this case, the Supervisory Authority does not approve the ICAAP documentation submitted by the institution or approves it with certain comments, or approves it, but stipulates additional capital requirement (in excess of the capital requirement applied by the institution itself), and requests measures to be taken regarding the level of risks and changing the risk management and business management methods.

In the above mentioned cases, the Supervisory Authority may act in accordance with Article 153 of the CIFE Act, in particular:

- The Supervisory Authority orders the institution in a "Prudential Letter" or "Resolution" to take action depending on the severity of the deficiencies of its risk management/corporate governance identified during the supervisory review.
- In addition to the risk management/corporate governance deficiencies, the Supervisory Authority deems the capital requirement presented in the ICAAP inadequate and calls for additional capital. The additional capital requirement is duly justified and documented to the institution concerned.
- The supervisory review identifies an extremely high risk level, therefore it sets a requirement for reducing it

5.2 Supervisory measures

The Supervisory Authority informs the management of the institution on the SREP results and its own expectation in a "Prudential Letter". This Management Letter closes the

SREP. If required, the Supervisory Authority issues not only a Prudential Letter but also a Resolution.

The Prudential Letter contains the following:

- executive summary,
- risk assessment for the main risk categories,
- capital deemed necessary based on SREP,
- risk mitigating measures, expected status,

The results of the SREP process must be documented on the SREP Review Form. The SREP Review Form constitutes Annex 2 of these Guidelines.

In the case of a banking group with an EU parent institution, the table titled “Summary information [on the] risk-based capital-adequacy of XY Group” serves as the SREP review form.

If the HFSA is the consolidating supervisory authority, it issues a resolution based on the joint decision at the end of the SREP. The resolution declares whether the consolidated solvency capital of the group is adequate with regards to its financial position and risk profile and also stipulates the additional capital requirement (if any) on a consolidated basis or for a specific group member. In case the authorities fail to pass the resolution within four months, the HFSA makes a final decision taking into consideration the risk analysis of the subsidiaries and the opinions of other competent supervisory authorities.

The HFSA sends the resolution to the competent supervisory authorities of other relevant member states and to the EU-level parent credit institution or the EU-level parent company of the financial holding. The HFSA updates the resolution annually or when the competent authority responsible for supervising the subsidiary requests it in writing and with strong reasons for setting an additional capital requirement. In the latter case, updating can also be performed bilaterally.

If the HFSA is not the consolidating authority, the resolution passed by another member state’s competent authority (consolidating supervisor) regarding the group’s solvency capital and additional capital requirement can be applied and enforced directly in Hungary. The HFSA publishes an announcement on its home page in Hungarian that a resolution has been passed by the consolidating supervisor. In the case of an organization that is subject to supervision by the HFSA, the execution of the resolution passed by another member state’s supervisory authority concerning the solvency capital and additional capital requirement of the group shall be governed by the same Hungarian legal provisions that apply to HFSA resolutions. This rule also applies to the verification of fulfilment of the consolidating supervisor’s resolution and to the resulting measures.

If the HFSA is not the consolidating supervisor and if the authorities fail to make a joint decision on the solvency capital and additional capital requirement of the group, the HFSA will decide on the additional capital requirement of the domestic institution.”



6 Acceptable differences between the capital requirement under Pillar 1 and Pillar 2

In this chapter we review those cases, when the capital calculation used in Pillar 1 differs from that in Pillar 2. We define the conditions, which should be met so that the differences applied under Pillar 2 could be acceptable for the Supervisory Authority, and determine the acceptable intervals for capital requirement differences. This chapter provides guidelines for institutions which do not apply the “Pillar 1+” method to calculate their capital requirement under Pillar 2.

The Supervisory Authority approves all duly justified differences that satisfy the conditions disclosed in advance regarding the ICAAP calculations under Pillar 2, but it set limits on the acceptable amount of those differences which would result in a decrease of capital requirement.

In defining Pillar 1 and Pillar 2 capital requirement, capital requirement may differ in Pillar 2 in the following cases:

1. when inter or intra risk diversification effects are taken into account,
2. when the calculation methods differ,
 - a. there are differences in the applied model
 - b. there are differences in the applied risk parameters (such as downturn or “normal” LGD),
3. when risk appetites differ (e.g. different targeted rating),
4. when other calculation, valuation or assessment differences exist.

Now we are going to review the four basic cases outlined above.

6.1 Taking into account the diversification effects

The conscious handling and measuring of diversification, and taking it into account in risk management, performance measurement or even in strategy indicates a more sophisticated risk management culture, and also a higher level of risk awareness. The handling of diversification also means the handling of concentration, since concentration is nothing else than imperfect diversification.

6.1.1 Definition of the diversification effect (benefit)

Essentially, diversification means that the risk of a given portfolio cannot be higher than ⁴⁰ the sum of the risks of its sub-portfolios⁴¹. The diversification effect or benefit is the difference of the two – i.e. the sum of the risks of sub-portfolios and the risk of the entire portfolio. The less the risks of the sub-portfolios correlate, the bigger the difference becomes.

⁴⁰ The individual exposures themselves may also be treated as (one element) sub-portfolios.

⁴¹ There is another element of diversification, namely that exposures should be divided more evenly. This issue, called “granularity”, is usually not considered in the discussion of the diversification benefit, therefore we also ignore this issue.

6.1.2 Calculating the diversification benefit

Diversification is only applicable if we measure risks. The real difficulty lies in the calculation of the total portfolio risk (including the diversification effect). The reason is that for this calculation we need assumptions⁴² regarding the interdependence of risk elements.

6.1.3 Conditions and restrictions on considering diversification effects

Although the existence of the diversification effect is widely accepted, its actual quantification is often questionable⁴³. Most supervisory authorities are rather cautious about this issue: it is not fully prohibited, but restricted while the conservative approach to handling is emphasised.

The caution seen at the supervisory authorities basically comes from the potentially significant decrease in the capital requirement, which is coupled, on the one hand by the lack of appropriate supervisory experience related to this issue and, on the other hand, by the high modelling risks, i.e. results depend on the selected risk measure, the background assumptions for joint distribution and dependencies, these are not easy to verify (or it is sure that they are not fully met), data are scarce, often only experts' estimates are available etc. The deficiencies of models were also highlighted by the recent crisis (e.g. asset correlation matrixes proved to be less stable); formerly developed models were often found to underestimate risks.

When carrying out the SREP, the HFSA does not exclude the possibility of considering the diversification benefit; however, when reviewing the individual institutions' ICAAP, the possibility of taking the diversification duly justified by the institution into account is considered individually, keeping the "usual" modelling expectations in view. The institution must explain the selection of the given model, examine whether the assumptions related to the model are satisfied, present the conclusion drawn from the use of other methods and parameter values⁴⁴ (sensitivity analysis, stress test) and, based on these, the institution should be capable of convincing the Supervisory Authority that the capital requirement calculated this way will be adequate even in the case of a more serious economic downturn, and special role should be provided to use tests and the ongoing validation of the models. In addition, for the purpose of the Supervisory Authority:

- Only those diversification effects may be verified, which are really measured (within well documented risks, which are determined by an internal model of adequate quality) (risks handled through more simple methods or capital buffering cannot be taken into account for diversification).

⁴² See ICAAP manual, Chapter III.3, "Aggregation of capital requirements, diversification"

⁴³ A typical example would be the use of the VarCovar method that heavily relies on assumptions without any further analysis or reasoning

⁴⁴ These tests (and reflecting their impact in a considerably conservative manner) are of great significance due to the high model risks (e.g. uncertainties of the correlation factors)

- Use tests and experience tests are required: to what extent the applied methods are integrated in the institution's procedures and used for capital planning, allocating, pricing and performance measurement purposes. The uncertainties in the model should be treated with a sufficiently conservative approach, using the results of sensibility tests.
- The institution needs to apply appropriate sensibility and stress test techniques which ensure acceptable outcomes even in a potential crisis situation.
- The models should be regularly validated and appropriately maintained.

In addition to the above conditions, the Supervisory Authority believes that it is necessary to restrict the consideration of diversification effects by setting the acceptable maximum capital requirement decrease caused by these effects:

- maximum 5-10% diversification effect is acceptable within the credit risk,
- as far as the market and operational risks are concerned, automatically the higher of the Pillar 1 or Pillar 2 values are taken into account in the calculation of the capital requirement. This is explained by the fact that an internal model covering the diversification effects may be used even under the Pillar 1, and there is no reason why this model could be used only under Pillar 2.
- 5 to 10% diversification effect between Pillar 1 risks is accepted,
- 5-10% diversification effect may be accepted between Pillar 1 and 2 risks (relative to the sum of all the values accepted in SREP so far)

The above calculation method is illustrated through the following example:

Capital requirement	Pillar 1	ICAAP (incl. diversification)	Diversification effects in ICAAP	SREP
<i>Pillar 1 risks</i>				
Credit risk	80	65	-10	72
Market risk	10	5	-2	10
Operational risk	10	11	-2	11
Diversification inter risks (between Pillar 1 risks)		-10	-10	0
	100	71	-24	93
<i>Pillar 2 risks</i>				
		5		5
Interest rate risk (banking book)		2		2
Country risk		0		0
Settlement risk		2		2
Other risk (1)		1		1
Other risk (2)			-4	-4
Diversification inter risks (between Pillar 2 risks)		-4	-3	-4
Diversification inter risks (between Pillar 1 and 2)		-3		-3
	100	74	-31	96
<i>Stress test</i>				
Stress test		6		6
Capital requirement	100	80	-31	102

Remarks:

For the purpose of simplicity, all limits expressed as a percentage are 5% in this example.

1. It is assumed that in the case of risks under Pillar 1, Pillar 1 and ICAAP figures differ only due to inter risk diversification and differences in models.

2. 5% may be deducted from Pillar 1 credit risk capital requirement due to diversification and further 5% due to modelling differences (it is assumed that the institution justified the differences and the Supervisory Authority accepted the explanation).

3. It is assumed that market and operational risks are calculated by the standard method in Pillar 1, while in Pillar 2 an internal model was applied, accepted by the Supervisory Authority. It is assumed that the capital requirement of risks under Pillar 2 was also calculated based on models approved by the Supervisory Authority.

4. Market risks are not reduced due to diversification and modelling differences, since the model is not applied in Pillar 1. If it were applied there, the resulting value (5) could be accepted, in case the Supervisory Authority found it appropriate.

5. For operational risks the higher ICAAP value is accepted, since this internal model obviously describes the risk more accurately than the standard method applied in Pillar 1.

6. The Pillar 1 inter-risk diversification effect is not accepted as no advanced methods are used in Pillar 1 for market and operational risks. If Pillar 2 models were applied in Pillar 1, then 5 out of the 10 diversification benefit could be accepted (5% of total Pillar 1 capital requirement), and therefore SREP would include $72+5+11-5=83$ capital altogether for Pillar 1 risks.

7. It is assumed that other diversification and Pillar 2 figures are found correct (together with the security surplus arising from the stress tests), therefore these are accepted as they are. Pillar 2 diversification is accepted since it is assumed that all those risks are handled by advanced models, and the diversification between Pillar 1 and Pillar 2 is also accepted as it (3) does not exceed 5% of the already approved SREP numbers (99).

6.2 Differences in calculation methods

Compared to the capital requirement calculated for Pillar 1, the institution may come up with a different result, if it used a method other than “Pillar 1 +”.

In Pillar 2, the institution may freely choose the methods to be applied; however, the institution is required to present that their calculation methods and the applied conditions can be realistically used in the Hungarian environment and these duly reflect the actual risks of the institution.

Nonetheless, the free choice of the methods does not mean that the Supervisory Authority accepts solutions that do not result in a risk assessment more accurate than the method applied under Pillar 1 and only make Pillar 1 conditions (weights, parameters) looser. In Pillar 1, advanced methods may be considered good approximations and this means that those, who cannot measure risks by such methods, i.e. use standard methods, have to take risk overestimation into account as a characteristic of standard methods. This cannot be avoided in Pillar 2, if the institution cannot prove that it used a risk assessment method more accurate than under Pillar 1.

The Supervisory Authority should make sure that the calculation differences compared to Pillar 1 are explained and truly reflect the risk profile of the institution. After the Supervisory Authority gains assurance of this, similarly as in the case of diversification effects, a lower Pillar 2 capital requirement is accepted compared to the Pillar 1 outcome with certain limitations.⁴⁵ However, not even this case could the institution’s regulatory minimum capital requirement be lower than the capital requirement under Pillar 1. According to the Supervisory Authority, differences arising from the calculation method are accepted up to 5-10% decrease in the capital requirement.

6.3 Differences in the risk appetite

The institutions may target a risk level other than used in Pillar 1.

The internal models applicable in Pillar 1 were developed on the following probability levels:

- credit risk: internal ratings based (IRB) method, 1 year, 99.9% VaR, assuming a specific model for the default of the payee.

⁴⁵ Based on the above, differences arising from various models are possible only for credit risks (and not for market and operational risks). However, differences related to parameters may arise for all three types of risks.

- operational risk: AMA also with 99.9% VaR, calibrated for 1 year.
- market risk: the trading book is set at a 99% probability level with a duration of 10 workdays.

Credit rating agencies expect the coverage of losses arising from credit risks by capital with the following probability level:

- AAA: probability exceeding 99.99%,
- AA: probability exceeding 99.97%,
- A: probability exceeding 99.93%,
- BBB: probability exceeding 99.8%.

The institutions may use a probability level other than that applied under Pillar 1 in accordance with the targeted credit rating under Pillar 2 in the economic capital calculation method, although this significantly affects the received capital requirement. The Supervisory Authority does not accept ratings below BBB for ICAAP calculations (i.e. the probability level is below 99.8% for one year).⁴⁶ (For all risks, a uniform and 1-year risk level should be applied.)

6.4 Other calculation, settlement differences

It is difficult to forecast all possible differences; therefore these are handled individually until appropriate experience is gained, taking the deviations discussed so far and the related limits into account.

As far as accounting and settlement differences are concerned, values should be recalculated in line with their interpretation under Pillar 1 (if possible).

6.5 Joint limit for restrictions and the timeline for application

It has to be emphasised that even in the case of a decrease in the capital requirement under Pillar 2, the institution's minimum regulatory capital requirement cannot be lower than the capital requirement under Pillar 1.

In line with the Supervisory Authority's current policy, the differences coming from the above-listed factors may be accepted, if the overall decrease in the capital requirement is maximum 10% (compared to Pillar 1 capital requirement for credit risks, and compared to the capital requirement for all Pillar 1 risk + all risks not or partially covered under Pillar 1).

These restrictions are maintained in accordance with the objectives and reasons discussed earlier only until we can make sure that this issue may be controlled using less prescriptive tools (it may take a couple of years).

Nevertheless, in exceptional cases we may deviate from the restrictions when it is clearly justified and the institution can prove that keeping the regulations would distort the capital requirement to a great extent.

⁴⁶ It is possible that (due to a uniform methodology in use at a group, for example) the internal capital calculation is done at a lower probability level (e.g. targeting the BB rating). In this case the institution is expected to communicate figures recalculated based on the BBB rating to the Supervisory Authority.

7 Supervisory Review Process applied to small institutions

In accordance with the ICAAP Guidelines, the Supervisory Authority intends to use the notion of proportionality in the SREP process, too. In relation to the application of the notion of proportionality small institutions are those that are defined so in the ICAAP Guidelines.⁴⁷ The application of the principle of proportionality does not mean that the Supervisory Authority does not require small institutions to comply with the requirements stipulated in the CRD, and other Hungarian regulations but it follows a simplified procedure during the inspection and the requirement of the compliance level in the case of small institutions.

In the case of small institutions the SREP is first of all based on information from a questionnaire survey and from the supply of data. (Annex 3. contains the Questionnaire designed for Small Institutions.) With this method it can be ensured that despite of the large number of small institutions all information that the HFSA requires for decision-making within the SREP are efficiently collected and processed. The Supervisory Authority conducts the questionnaire survey every year, and compares its results with information obtained from the supply of data, as well as from on-site or off-site inspections. Consequently, the HFSA can identify those institutions against which it must take actions within the framework of the SREP.

The definition of the additional capital requirement is not the only tool for measures taken within the framework of the SREP. Other tools may include calls for risk reduction, calls for the improvement of the quality of risk management, for the modification of the internal regulation, or for organisational change, the requirement of internal education and training, hiring of a new manager or expert.

Within the framework of the SREP the Supervisory Authority inspects all small institutions; however it does not intend to prescribe additional specific capital requirement for each institution; the HFSA aims to select that group in which it is rightly justified to impose HFSA measures, including especially the additional capital requirement. The capital requirement specified in Pillar 1 can theoretically be sufficient for small institutions that operate prudently, with proper capital adequacy, in case during the Pillar 2 processes (ICAAP, SREP) no further relevant risk elements are defined, and this is supported by the capital plan and the stress test, too.

Within the framework of the SREP, a supervisory measure shall be taken, **or additional capital requirement shall be prescribed for institutions** in the case of which any of the situations listed below exists, and if this is accompanied by a deficient internal control system, insufficiently covered by capital, and prudent operation is not guaranteed in general:

⁴⁷ Small institutions are institutions that satisfy most of the following criteria:

no complex activities, focusing only on a clearly defined group of products (relatively small market share)
no use of any advanced methods approved by the Supervisory Authority for the calculation of credit, operational or market risks / services provided primarily in the territory of Hungary without any major cross-border services / to be classified as a small institution according to its own opinion. The Supervisory Authority makes the final decision on whether or not an institution is considered a small institution.

- the institution operates under conditions that are riskier than the average (e.g. geographical environment, higher-risk clients),
- any of their ratios/indicators shows a higher risk level (e.g. bad asset quality, operational losses, liquidity difficulties, high interest rate risk, concentration risk, etc.),
- the Supervisory Authority or any other external inspection reveals a management, risk management or internal control problem,
- recent frauds, abuses or operational problems have been revealed that jeopardise long-term operation,
- the institution is engaged in an activity that is not typical for a small institution (e.g. cross-border services, developed trading of derivative instruments, purchase of foreign securities),
- the launch of new activities or the new market penetration that will presumably significantly influence the operation of the institution,
- in contrast with its strategic objectives, the institution loses a significant market share in its scope of operation, the number of its clients or volume of its business falls to a level that jeopardises further operation,
- the financial terms and conditions offered by the institution significantly differ from the usual market terms and conditions,
- the institution fails to comply with fundamental procedures specified in supervisory recommendations and methodological guidelines, which threatens prudent operation,
- the institution lacks management knowledge, expertise, or technical or IT conditions that would be indispensable for the activities it is engaged in, or the risks implied therein,
- the trust/credibility of the institution become questionable by its partners, clients,
- the institution's strategy cannot be regarded well-founded due to the expected macro-economic and sector-specific conditions, and the financial standing of the institution,
- the quality of the ICAAP applied by the institution is not adequate,
- the institution does not perform sensitivity or stress tests to determine the growth rate of its major risks in case of significant economic recessions, and the volume of capital needed to cover such risks. In case of credit risk the Supervisory Authority prescribes an additional capital requirement equalling 10% of the minimum capital requirement, if the institution cannot prove that it requires less capital for secure operation in stress situations.
- the ownership relations of the institution do not make efficient owner control possible,
- if the institution is a cooperative credit institution, and it is not member in any institution protection fund.

The prescribed capital requirement shall be in line with the results of the quarterly monitoring, and information obtained during on-site and off-site inspections shall also be used.

In case the institution finds that it needs a higher capital requirement during the application of the ICAAP, and the Supervisory Authority does not prescribe additional capital requirement above that sum, the HFSA will regard the higher capital requirement calculated by the institution as the capital requirement in Pillar 2.

7.1 Supervisory measures

Typical supervisory measures, including the requirement of additional capital with regard to small institutions and in line with the various risk categories

In line with the methodological guidelines issued on the ICAAP, the HFSA inspects the need for supervisory measures or additional capital requirement according to the following risk categories or groups:

- I. Environment**
 - External risks
- II. Corporate governance**
 - Exercising of the ownership rights
 - Strategic risks
 - Internal governance
 - Internal control system
- III. Market presence**
 - Products and services
 - Client risks
 - Unauthorised activities
 - Unfair market manipulation
- IV. Business processes and capital**
 - Credit risk
 - Market risk
 - Interest rate risk
 - Liquidity risk
 - Operational risk
 - Capital and profitability
 - Concentration risk (specific clients, geographical)
 - Other risks

The effective Hungarian legal regulations specify the maximum additional capital requirement that can be prescribed within the framework of the SREP as the amount of the capital requirement calculated according to Pillar 1, which amount can be increased with the additional capital requirement prescribed within the framework of the extraordinary measures.

The relationship between the deficiencies revealed at small institutions and the supervisory measures to be taken within the framework of SREP are shown in table 1. The HFSA provides the table, the categorisation of deficiencies and the percentage of the additional capital requirement as a starting point. In reality other aspects may arise and be considered.

Based on their significance, the revealed deficiencies and problems are put into three categories. Category I indicates the most serious, while Category III indicates minor deficiencies. In case only Category III problems are revealed at an institution, the HFSA will not necessarily prescribe additional capital requirement, or the amount of

the additional capital requirement will not exceed 33% of the capital requirement calculated in Pillar 1. The more Category III typed deficiencies are revealed, the value of the additional capital requirement is closer to 33% of said amount.

In case Category II or Category I problems are detected, the additional capital requirement prescribed by the HFSA shall be 0 to 66% and 0 to 100%, respectively, depending again on the number of other deficiencies, and the categorisation of the deficiencies in the institution's operation.

In case the given problem or deficiency is eliminated, it will be taken into account by the HFSA during the next SREP.

1. Table: Supervisory response to the detected deficiencies

Risk category/risk element	Detected deficiency	Supervisory measure	Problem category	Primary sources of information
I. Environment				
1. External factors	1.1. Operating in a risky environment; negative impacts of macro-economic cycles	Request for the diversification of activities	II	Data supply, questionnaire, supervisory examinations
	1.2. High geographic concentration risk	Closer attention to risk management	III	Questionnaire, supervisory examination, sector analysis
	1.3. Lack of membership in an organisation protecting institutions	Closer attention to risk management	I.	Questionnaire, data supply
II. Corporate governance				
1. Exercising of the ownership rights	1.1. Lack or weakness of owner's control	Request for stronger owner's control	III	Data supply, supervisory examination
2. Strategic risks	2.1. The institution's strategy is not well established	Request for changing the strategy	II	Supervisory examination, data supplies
	2.2. The owners' dividend policy does not provide for the necessary internal capital increase	Calling the owners' attention to the potential problems	II.	Questionnaire, data supply
	2.3. Loss of confidence (reputation risk)	Closer supervisory observation of the activities	I.	Supervisory examination, market information, questionnaire
3. Internal governance	3.1. Lack of professional knowledge, experience of top managers.	Order to eliminate deficiencies, and organise training	I	Examinations of the Supervisory Authority and other organisations, experiences of prudential meetings.
	3.2. Problems related to the qualification and professional experience of executives out of the scope HFSA	Request for professional training	III	Questionnaire, supervisory examination
	3.3. Contravention of the supervisory authority's former resolution	Order for compliance with the resolutions of the Supervisory Authority, penalty	I	Questionnaire, supervisory examination
	3.4. Contravention of the supervisory authority's recommendations and methodology guidelines	Requesting compliance with recommendations, guidelines	II	Supervisory examination
	3.5. Not taking in account other notifications of the supervisory authority (such as Management Letter,	Closer observation of compliance with other	II.	Questionnaire, supervisory examination

	Management Circular Letter)	notifications of the supervisory authority		
4. Internal control system	4.1. The Supervisory Authority or other external inspection reveals management/control, risk management or internal control problems	Request for the rectification of risk management and audit deficiencies	I	Examination documents of the Supervisory Authority and other organisations
	4.2. Substantial deficiencies in the market risk management and control system	Request for the rectification of risk management and audit deficiencies	I	Supervisory examination, data supply
III. Market presence				
1. Products and services	1.1. Services and products offered by the institution are non-marketable and do not satisfy market/clients needs	Request for the modification of the product and service range	III	Examination documents of the Supervisory Authority and other organisations, data supply
	1.2. Performance of activities, not typical of small institutions	Closer supervisory observation of the activities	III	Questionnaire, supervisory examination, data supply
	1.3. New types of activities, markets	Closer supervisory observation of the new activities and markets	III	Data supply, supervisory examination, questionnaire
	1.4. Decreasing market share/growth rate below the sector average	Request for the modification of the business policy	III	Data supply, supervisory examination, questionnaire, HFSA analyses
2. Client risks	2.1. High portfolio concentration by product or debtor age, insufficient composition of clientele.	Request for the modification of the client structure	II	Examination documents of the Supervisory Authority and other organisations, data supply
3. Unauthorised activities	3.1. Supervisory or other authorities reveal unauthorised activities	Obligation to terminate the unauthorised activities	II	Examination documents of the Supervisory Authority and other organisations, data supply
4. Unfair market manipulation	4.1. The institution uses non-permissible tools in their acquisition, marketing and disclosure policies.	Request for the modification of acquisition, marketing and disclosure policies	II	Examination documents of the Supervisory Authority and other organisations, data supply

IV. Business processes and capital				
1. Credit risk	1.1. The quality of assets is in the bottom 10 to 20% compared to similar credit institutions	Request for a decrease in credit risks	III	Data supply
	1.2. The quality of assets is in the bottom 10% compared to similar credit institutions	Request for a decrease in credit risks	II	Data supply
	1.3. Substantial lending loss in the past three years exceeding 5% of the equity.	Investigation of the source of credit losses	II	Supervisory examination, data supply, questionnaire

	1.4. The rate of suspended interests exceeds five per cent of the outstanding principal receivables and is at least 30% higher than the sector average.	Investigation of the source of credit losses	III	Data supply
	1.5. Substantial deficiencies in credit risk management and control system	Request for the rectification of risk management and audit deficiencies	I	Supervisory examination, examination documents received from other organisations
	1.6. Clients, representing higher credit risk than average based on their ratings and industry risks	Request for more detailed reports and stricter risk management procedures	III	Questionnaire, supervisory examination
	1.7. Introduction of new loan products, unusual and new in the Hungarian market.	Observing of new products	III	Questionnaire, supervisory examination
	1.8. The credit institution operates with ratios close to the prudential limits described in Articles 76-85 of the CIFE Act (higher than 90% ratios)	Closer observing of ratios, prudential limits	III	Data supply
	1.9. Average LTV (loan-to-value ratio) above 70% backed only by mortgage collateral	Observing of real estate related financing	III	Questionnaire, examination documents of the Supervisory Authority and other organisations, data supply
	1.10. High country risk	Closer supervisory monitoring of the activities	Surplus capital requirement required based on separate methodology	Data supply
2. Market risk	2.1. Substantial losses in the last three years arising from market risk	Investigation of the source of losses arising from market risks	II	Questionnaire
	2.2. Products with exceptional conditions	Request for the review of conditions	III	Supervisory examination, questionnaire
3. Interest rate risk	3.1. Interest rate sensitivity analysis indicates high risk	Request for the improvement of interest rate risk management techniques	Surplus capital requirement required based on separate methodology	Supervisory examination, data supply

4. Liquidity risk	4.1. Frequent liquidity problems, limited access to additional capital, GAP analysis indicates maturity mismatch.	Request for the improvement of liquidity risk management techniques	II.	Questionnaire, data supply, supervisory analysis
5. Operational risk	5.1. Substantial losses in the last three years arising from operational risk	Investigation of the source of losses arising from operational risks	II	Questionnaire
	5.2. Outsourcing of significant activities; no proper attention is paid to the outsourced activities and/or the assigned external company.	Request for closer attention paid to the outsourced activity	III	Data supply, supervisory control, questionnaire
	5.3. Administrative problems (not only operational risk related problems)	Request for the elimination of administrative deficiencies	II	Supervisory examination, client complaints, data supplies
	5.4. IT deficiencies	Request for the elimination of IT deficiencies	II	On and off-site examinations, client complaints
6. Capital and profitability	6.1. The ICAAP value is higher than under Pillar 1		Additional capital requirement in accordance with the ICAAP value and the result of the supervisory risk assessment	Questionnaire, data supply
	6.1. Decrease of own funds compared to the end of the previous year exceeding 10%.	Setting an obligation to prepare a capital plan	II.	Data supply

7.2 Closing the review of small institutions

Following the processing of the questionnaires, the Supervisory Authority informs the institutions on the result of processing (as well as the outcome of any consultations) With regard to small institutions this is done in a SREP Review Report, structured as follows:

- executive summary,
- risk assessment based on the monitoring system,
- ICAAP review result, SREP capital requirement,
- risk mitigating measures, expected status.

Annexes:

- 1 Annex: Information on High-Risk Portfolios and on Related Additional Capital Requirement as Key Priorities in the Supervisory Review Process (SREP)**
- 2 Annex: SREP Review Form**
- 3 Annex: Questionnaire for Small Institutions**