



## GUIDELINES

### **On the authorisation of the use of the standardised approach for the calculation of the capital requirement for operational risk**

Guidelines No. 10 (Guidelines on the validation and assessment of Advanced Measurement (AMA) and Internal Ratings Based (IRB) Approaches) published by the CEBS (Committee of European Banking Supervisors) on 3 April 2006 allow for a preliminary authorisation to be required for the use of the Standardised Approach for the calculation of the capital requirement for operational risk. This approach was adopted by the amendment of the Act on Credit Institutions and Financial Enterprises (ACI) that was passed on 4 June 2007 and became effective as of 1 July 2007<sup>1</sup>. The use of an alternative indicator within the Standardised Approach for retail banking and commercial banking business lines is subject to the fulfilment of additional conditions, and thus also subject to a preliminary authorisation<sup>2</sup>.

These Guidelines describe how a supervisory authorisation procedure can be requested, how it is scheduled, the requirements for the contents of the documents to be attached to the application for authorisation and the work methods employed by the HFSA in the course of the authorisation process.

#### **I. Deadlines**

When developing the authorisation process the HFSA focused on calculability and transparency. In setting the deadlines, it considered the provisions of the ACI<sup>3</sup> and the time requirements for any possible discussions that may follow the submission of an application, as well as the time requirement for decision making by the HFSA:

The institution applying for an authorisation must submit its application once it has completed preparations for the application of the approach and at least 180 days prior to the planned date of application.

#### **II. Application for authorisation on the solo level**

When applying for authorisation, the institution must submit a cover letter and the documentation pack.

The cover letter is the actual official application for authorisation, in which the institution indicates the approach (Standardised or Alternative Standardised Approach) that it intends to use.

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<sup>1</sup> ACI Article 14 Paragraph (1) u); ACI Article 76/J Paragraph (3)

<sup>2</sup> ACI Article 76/J Paragraph (6); Government Decree 200/2007 Article 6 Paragraphs (3) and (4)

<sup>3</sup> ACI Article 194

Within the application the institution must state that the contents of the attached documents are true and fair, and despite their summary nature contain all essential information for the assessment of the application.

The application must be signed by the topmost executive (Chief Executive Officer or Chairman and Chief Executive Officer) of the institution and by the executive member of the Board of Directors responsible for risk management. The cover letter must also identify the name of the contact person designated by the institution.

For an application for authorisation on the solo level the language of the cover letter should be Hungarian while the language of the other elements of the documentation pack may be Hungarian as well as English, all materials to be submitted in electronic form on CD. The cover letter is to be submitted on paper as well.

Apart from the indication of the approach chosen, an application for authorisation to use the alternative indicator is not different from that for the Standardised Approach. The documentation is also based on the documentation for the Standardised Approach, except that for the use of an alternative indicator the documentation must also contain the documents aimed at demonstrating that the related additional conditions are also satisfied.

## **II. I. Documentation pack contents**

The regulation of the topics discussed in these Guidelines is aligned with the internal regulations of the applying institution (group), i.e. the individual topics need not be dealt with in separate regulations and separate documents by topic, as it is also not a requirement to have codified regulations covering all aspects of operational risk management. The HFSA assesses the regulations developed by the institutions on their substance. If the regulations concerning operational risk appear in various different regulations of the institution, a list of references is required to show exactly which part or parts of which regulations discuss the individual topics (of the below list for example it may be expedient to supplement the list of regulations).

Standardised Approach:

- List of regulations for fields related to operational risk (list only);
- The organisation of risk assessment and risk management, its regulation, decision making levels, contents and frequency of management reports (expediently by providing a copy of the most recent such report);
- Regulations for business line mapping and the calculation of the relevant indicator, regulations for the calculation of the overall capital requirement;
- The document providing quantitative proof for the fulfilment of conditions for any derogation<sup>4</sup> requested with regard to the trading and sales business line;
- Records of exceptions made by the institution in business line mapping at the time of implementation and of decisions complementing or overruling the general principles (to be continuously maintained later);

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<sup>4</sup> Government Decree 200/2007 Article 16

- Regulations on the collection of loss data;
- The attached Excel file, filled in, containing the results of the calculation of the relevant indicator and of the business line mapping;
- Self assessment: a summary prepared by the institution, in which it assesses for itself the results achieved regarding the points listed under the Authorisation Procedure section (Part IV) of these Guidelines, as well as the additional steps necessary and planned in order to eliminate the deficiencies identified. We request that you indicate in your self assessment whether the institution is a member of a loss data consortium, providing its specific name if yes;
- The regulations related to carrying out an independent review;
- Any documents that could, in the view of the institution, demonstrate its preparedness.

Alternative indicator (in addition to the general documentation for the standardised approach as listed above):

- Quantitative proof for the fulfilment of the condition<sup>5</sup> for the 90% dominance of the retail and commercial banking business lines;
- Proof, as required by statutory regulations, for the high credit risk of a significant portion of the retail and commercial banking business lines<sup>6</sup>;
- Proof for the regulated and consistent use of risk based pricing;
- Proof that the use of the alternative indicator results in a better estimate for the operational risk exposure.

### **III. Differences for applications for group level authorisation**

For a group of institutions, the institution leading or controlling the group may submit a single application to apply for the group level authorisation as well as for the individual authorisations of the group members obliged to create a capital requirement for operational risk on the solo level. In this case however, it is required that the individual group members duly authorise the institution controlling the group for proceeding vis-à-vis the HFSA in their name and on their behalf.

The application must be signed by the topmost executive (Chief Executive Officer or Chairman and Chief Executive Officer) of the institution leading or controlling the group of institutions, and by the executive member of the Board of Directors responsible for risk management on the group level. The cover letter must also identify the name of the contact person designated for the entire group of institutions.

#### **III. 1. Differences for the contents of the group level documentation pack**

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<sup>5</sup> Government Decree 200/2007 Article 6 Paragraph (3)

<sup>6</sup> Government Decree 200/2007 Article 6 Paragraphs (3) b) and (4)

The documentation pack for the group-level application for authorisation must include the list of group members subject to consolidated supervision and thus to be considered for the calculation of the capital requirement for operational risk on the group level, as well as the list of group members obliged to create a capital requirement on the solo level and not using the Standardised Approach or an alternative indicator. For each individual group member a list is to be provided of the operational risk business lines where the specific institution is active.

The scope of consolidated entities corresponding to the consolidated data provision to the HFSA on the basis of the relevant indicator (including also the alternative indicator) and the business line data included in the group level documentation pack.

Deviations from the general solutions employed by the group are to be indicated for each individual group member in the corresponding part of the documentation pack, including the reasons for the deviations, as well as any modifications or improvements already planned, with their time schedules and the group members affected by the improvements.

#### **IV. The authorisation procedure**

The HFSA first examines submitted applications for completeness. If the HFSA finds that certain elements specified under Chapters II and III are missing from the application, it will instruct the applicant to submit the missing information.

With regard to the assessment of the content it may be necessary to conduct discussions in person and to perform on-site appraisals of the systems used. An on-site investigation conducted for the assessment of an application is to be considered an investigation as specified under Paragraph (2) of Article 38 of Act CXXXV of 2007 on the Hungarian Financial Supervisory Authority<sup>7</sup>. The institution is informed of the investigation start date, but unlike with investigations conducted in the course of supervision, when conducting an investigation in the course of an authorisation procedure the HFSA need not inform the institution in writing 15 days in advance of the start of the investigation. For the same reasons, no report is prepared of the investigation and any deficiencies found by the HFSA will be summarised in the resolution to grant or to deny the authorisation.

Assessment includes the assessment, extending to every detail, of the systems and regulations for the calculation of the capital requirement and the measurement and management of operational risk, in order to enable the HFSA to determine the following:

- Whether the management of operational risk is properly integrated into the overall management of risk by the institution (group);
- Whether group relationships are adequately identified and managed for institutions belonging to a group;
- Whether the involvement of senior management in the operation and improvement of the system and the information provided to senior management is in proportion to their decision making powers and responsibilities and whether they receive adequate support from the management reporting system;

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<sup>7</sup> Article 38 Paragraph (2) „The HFSA may perform an on-site investigation to confirm whether certain conditions for authorisation are met.”

- Whether the system and the regulations for the calculation of the capital requirement are consistent, whether individual solutions and ad-hoc decisions are justified and recorded, whether responsibilities are straightforward;
- Whether the calculation of the capital requirement and the collection of loss data extends to every activity performed by the institution (group);
- Whether the outcomes of the identification and measurement of operational risks arrive on time and with the proper content to the areas and the levels with the powers to make decisions on the operational management of risk;
- Whether the staff actually performing the individual activities are actively involved in the identification, measurement and management of operational risks;
- Whether feed-back loops operate properly;
- Whether the institution ensures the independence of the organisation unit and person responsible for the management of operational risk;
- Whether the identification, measurement and management of the operational risk exposure is developed and operated to a standard that is appropriate for the size, complexity and growth of the institution (group);
- Whether the institution (group) complies with all other minimum requirements set in statutory regulations or set by the HFSA.

## **V. Outcomes of the authorisation procedure**

The HFSA communicates the outcome of the authorisation procedure in the form of a resolution, where the possible outcomes may be as follows:

Standardised Approach:

- Authorisation for the use of the Standardised Approach;
- Rejection of the application for the authorisation to use the Standardised Approach. If the application is rejected, the institution is obliged to use the Basic Indicator Approach.

Alternative Indicator:

- Authorisation for the use of the Standardised Approach with an alternative indicator;
- If the application is rejected:
  - The institution is authorised to use the Standardised Approach (but not with the alternative indicator); or
  - The institution is not authorised to use the Standardised Approach; it is obliged to use the Basic Indicator Approach.

In the case of a group-level application for authorisation, the resolution concerning the group-level application may differ from the decision for the solo level. A group-level authorisation may not be issued if the leading/controlling institution of the group does not itself meet the requirements on the solo level; this however has no influence on the authorisations for the solutions of the group members on the solo-level if they meet the requirements specified in statutory regulations.

## **VI. Other**

Institutions that have started their operations sometime during the two calendar years prior to the year when they are submitting their application, should use their business plan for the calendar year in which they are submitting their application as the basis for completing the Excel file that should include the results of their calculations for the relevant indicator and their business line mapping. If the authorisation is granted, the calculation of the capital requirement should be based on the business plan for the specific year as long as the institution does not have data for three complete calendar years.

Following the publication of the Government Decree regulating the management of operational risk at investment firms and the calculation of their capital requirements, the HFSA may amend its requirements for investment firms in line with the contents of the Decree if it deems it necessary.