



THE CENTRAL BANK OF HUNGARY

**European Commission
European Banking Authority
European Systemic Risk Board**

Ref.no.: 194595-1/2015
Budapest, 9 October 2015

Subject: Magyar Nemzeti Bank, the central bank of Hungary - Notification of the intended use of the Systemic Risk Buffer to mitigate systemic risks stemming from problem project exposures

Dear Colleagues,

Please find enclosed a document whereby Magyar Nemzeti Bank, the central bank of Hungary notifies you of the intended use of the Systemic Risk Buffer in accordance with Article 133 (11) of Directive 2013/36/EU. The credit institutions concerned will be required to hold the buffer effective from 1 January 2017.

Yours Sincerely:

MAGYAR NEMZETI BANK

A handwritten signature in purple ink, appearing to read 'B. Virág'.

Barnabás Virág
Executive Director
Monetary policy, Financial Stability and Lending Incentives

Enclosure: Magyar Nemzeti Bank – Notification of the intended use of the systemic risk buffer (SRB)

Enclosure

Notification of the intended use of the systemic risk buffer (SRB)

1. Notifying national authority (If several designated authorities, please mention all of them)											
1.1 Name of the notifying authority	Magyar Nemzeti Bank (MNB)										
2. Buffer levels and the institutions to which they apply											
2.1 Type of measure intended (also for reviews of existing measures)	Activation of a new SRB										
2.2 Buffer level	<p>As the MNB sets SRB rates up to 2 per cent, the measure is subject to the 'notification only procedure' under Article 133 (11) of the 2013/36/EU Directive (CRD).</p> <p>Institution-specific SRB rates will be set in the range of 0 to 2 per cent. The size of the SRB rate depends on the contribution of institutions to the systemic risk stemming from problem project exposures. These are defined for the purposes of the SRB as:</p> <ul style="list-style-type: none"> the gross amount of domestic commercial real estate project loans if these: <ul style="list-style-type: none"> have been non-performing for more than 90 days, are restructured, with the exception of loans restructured more than a year ago that have become performing loans since, and other project loans that are deemed non-performing by the financial institution; the gross amount of domestic on-balance sheet held-for-sale commercial real estate. <p>The contribution to the systemic risk is measured by the ratio of problem project exposures to the sub-consolidated domestic Pillar I. capital requirement.</p> <table border="1"> <thead> <tr> <th>The ratio of problem exposures to domestic Pillar I. capital requirements</th> <th>Buffer rate</th> </tr> </thead> <tbody> <tr> <td>0.00 – 29.99 %</td> <td>+0.0%</td> </tr> <tr> <td>30.00 – 59.99 %</td> <td>+1.0%</td> </tr> <tr> <td>60.00 – 89.99 %</td> <td>+1.5%</td> </tr> <tr> <td>above 90.00 %</td> <td>+2.0%</td> </tr> </tbody> </table> <p>A de minimis rule shall also apply: institutions with problem project exposures below HUF 5 billion are exempted from the SRB requirement.</p>	The ratio of problem exposures to domestic Pillar I. capital requirements	Buffer rate	0.00 – 29.99 %	+0.0%	30.00 – 59.99 %	+1.0%	60.00 – 89.99 %	+1.5%	above 90.00 %	+2.0%
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above 90.00 %	+2.0%										
2.3 Institutions covered by the intended SRB	The measure shall be applicable to all credit institutions authorised in Hungary (thereinafter: credit institutions) that are within the scope of the EU/575/2013 Regulation (CRR). The SRB shall be applicable to all credit institutions with problem project exposures above the de minimis limit.										

	<p>Credit institutions shall apply the measure on a sub-consolidated basis. SRB formed in CET1 capital will be required only on domestic exposures (RWA), thus the intended SRB excludes exposures to other Member States or to third countries.</p> <p>Institutions that will be required to maintain other than zero SRB rate are to be identified in the fourth quarter of 2016 based on data provided for the third quarter of 2016. The MNB has worked out a dedicated quarterly data reporting requirement to support a full review of the risks related to problem project exposures (including project loans and repossessed commercial real estate exposures) on a sub-consolidated level and to ensure the basis for operationalising the SRB.</p>
3. Reasons for the intended SRB	
<p>3.1 Description of structural systemic risk (Article 133.1 of the CRD)</p>	<p>The currently high ratio of the problem project exposures in the Hungarian banking sector is a key macroprudential risk.</p> <p>Although non-performing portfolios may be regarded as a natural accompanying feature of banking, if they increase too fast and persist for too long, they pose severe problems to financial stability through several channels, finally hampering the banking sector's contribution to economic growth (e.g., in corporate lending).</p> <p>The NPL ratio of project loans in the Hungarian banking sector is much higher (~25 per cent) than the slowly decreasing NPL rate of total corporate loans (~15 per cent), and the rate has permanently stabilised on these high levels for more than 3 years now. These facts, however, does not grasp the full range of the problem, as the stock of continuously restructured loans is also persistently high, and repossessed collateral from defaulted loans contributes also to the systemic risk. The stock of problem project exposures therefore represents an issue even greater than NPL rates would suggest. The stock in question at the end of the second quarter of 2015 reached around HUF 730 billion (~EUR 2.4 billion) and made up approximately 45 per cent of total domestic project loans.</p> <p>Moreover, the large stock of problem project exposures further increases stability risks due to being highly concentrated. Currently, 10 banks own most of the stock of problem exposures, and 3 banks own almost 70 per cent of all problem project exposures.</p> <p>The exposure in question is not only nominally large; the stock can reach up to 1.5-3 times the size of the Pillar I. capital requirement of the affected institutions.</p> <p>Overall it is of public interest from a macroprudential point of view to intervene into this problematic segment and encourage institutions to either take steps in order to curb the volume of distressed portfolio exposures and/or to enhance their shock absorbing capacity to the level where systemic risks are also internalized.</p>
<p>3.2 Analysis of the potential to have serious negative consequences to the financial system and the real economy in your Member State</p>	<p>The high and persistent project loan NPL rate carries significant risk to financial institutions, as a large portion of the projects in question are backed by commercial real estate that is not expected to become income (cash-flow) producing in the near future.</p> <p>Problem project exposures threaten financial stability through a</p>

	<p>number of channels:</p> <ul style="list-style-type: none"> • Impact on profitability: As the stock of distressed project loans increases, so do impairment losses, which negatively effects the profitability of banks, and which weakens the ability of institutions to accumulate capital. Furthermore, NPL stocks in such volume can tie down significant resources, which can again lead to deteriorating profitability (if, e.g., employees are assigned to workout activities instead of loan origination). The need to continuously finance the unimpaired part of non-performing loans also decreases profitability. The cost of financing can also increase due to high NPL rates, as investors pay close attention to NPL in their risk evaluation; high NPL rates therefore can increase the risk premium on bank liabilities. • Impact on lending: As non-performing project loans tie down financing resources, the banking sector's lending capacity might weaken in case of effective liquidity limits, which leads to decreased lending. High NPL rates can limit lending not only through lower capacity, but also through negatively affecting the willingness for lending: high NPL rates make banks over-cautious, lowering their willingness to take on more risk in financing investment and growth in the corporate segment. • Impact on collaterals: A change in the value of collaterals or, in case of FX loans, in the exchange rate, can increase impairment losses. In an extreme scenario, in case of a deeper crisis, the value of collaterals can nosedive, leading to significant system-wide consequences in such moderately liquid markets like the one for commercial real estate. <p>It is important to mention that the impact of problem project exposures is multiplicative in nature, i.e., the impact of the total system-wide risk is greater than the sum of the impacts of the risks of individual institutions due to, e.g., possible system-wide fire sales and the currently moderately liquid market for the repossessed commercial real estates.</p>
<p>3.3 Indicators used for activation of the measure</p>	<p>The following indicators are used for the activation of the SRB and the monitoring of the targeted macroprudential risk:</p> <ul style="list-style-type: none"> • Stock of total and domestic non-performing project loans and its ratio over total and domestic project loans • Stock of total and domestic restructured project loans and its ratio over total and domestic project loans • Stock of total and domestic problem project exposures and its ratio over total and domestic project exposures • Total domestic problem project exposures over domestic Pillar I. capital requirement (calibration indicator) • Concentration of problem project exposures in the banking sector <p>In case of all indicators, persistency through time is also taken into account.</p>

<p>3.4 Justification of the scope of the SRB</p>	<p>The SRB is only applied to credit institutions that significantly contribute to the systemic risk of problem project exposures. The SRB is aimed at strengthening their loss absorbing capacity to the level where systemic risks are also internalized. These systemic risks that come on top of institution-specific risks already covered by Pillar 2 additional capital requirements are a result of several factors. Due to the high geographical concentration of these properties and land in distress, a lot of non-performing project loans have no prospect of becoming income generating in the near future. Capital buffers over Pillar 2 requirements are also warranted for scenarios of sudden exchange rate deterioration as the majority of these loans is denominated in FX and any simultaneous increase in the payment obligations can result in further fire sales or any other detrimental system-wide reaction. On the other hand, if banks react to the increased capital requirements by cleaning off problem project portfolios it can result in the mitigation of systemic risk, which a decrease in the required SRB rate can follow due to the yearly revision frequency. As a relatively long phase-in period is set (until the third quarter of 2016), affected institutions have the opportunity to accommodate and therefore to moderate or avoid currently expected capital add-on levels.</p> <p>Other regulatory measures have proven to be insufficient for the mitigation of the systemic risk in question.</p> <p>Non-performing project exposures (both loans and repossessed real estates) have been deemed significantly risky during the SREP for all relevant institutions in the last 3 years. The buffer levels have been set at strictly high levels (the risk weights have been increased by 100 per cent for both exposure types) for the past three years, but the SREP capital add-on has not been able to completely address the systemic risk of the exposures in question. Furthermore, the total SREP add-on is capped at 250% in Hungary, which means that there is a limit to how much capital add-on can be prescribed for problem project exposures within the framework of the SREP. Therefore, the SREP capital add-on does not cover the full spectrum of the risks in question, and it is also limited in its capacity to ensure the necessary level of shock absorbing capacity or the necessary incentives for any prospective resolution of the problem, e.g. via asset cleaning.</p> <p>Article 124 and 164 measures of the Capital Requirements Regulation (CRR) are primarily devoted to preventing the emergence of asset bubbles, and they do not differentiate among newly issued and outstanding exposures, thus they are not capable of tackling current systemic risks originated from problem project exposures. Moreover, in the case of project loan exposures the value of the property materially depends upon the credit quality of the borrower, the exposures are deemed unsecured for the purposes of determining their risk weight. This means that there is no room for macroprudential measures within these articles to handle the targeted challenge.</p>
<p>3.5 Suitability, effectiveness and proportionality of the measure</p>	<p>The SRB is a suitable instrument for the treatment of problem project exposure risk as it is supposed to target any non-cyclical systemic risk in Member States. Non-performing project loans definitely pose a structural systemic risk that is concentrated and has remained high for a relatively long time despite sequential Pillar 2 measures, and pose a burden on the balance sheet of several major banks in Hungary. The SRB is able to target this risk as it can</p>

	<p>be levied on the combination of exposure classes that are deemed to be the most problematic.</p> <p>This measure is effective, as it increases the affected credit institutions' shock absorbing capacity to the level that internalizes systemic level risks as well in order to withstand the effects of collective exposure and collective inaction in problem resolution. On the other hand if banks eliminate problem project exposure risks, it can facilitate the mitigation of the systemic risk. The chosen definition of problem project exposures (as explained above), the level of application and the targeted data reporting requirement will minimise the room for the circumvention of the macroprudential measure.</p> <p>The measure is proportionate, as it is directly linked to the contribution of the institutions to the systemic risk identified. It is derived from the ratio of the gross amount of problem project exposures to the domestic Pillar I capital requirement. The capital surcharge is capped at 2%. The "de minimis" limit of HUF 5 billion ensures that only systemically relevant exposures are taken into account.</p>
<p>3.6 Assessment of the likely impact of the internal market</p>	<p>As only Hungarian exposures are taken into account, the MNB does not expect significant impact of the measure on the functioning of the internal market. No significant negative spillover effects on other countries are anticipated, as the buffer will be prescribed based on domestic exposures only. The long phase-in period also promotes smooth accommodation to the measure.</p> <p>The MNB does not expect the recognition of the measure and the buffer rates by other national authorities (reciprocity) either regarding the cross border lending by credit institutions authorised in other EEA Member States, or concerning the branch offices, or in respect of capital buffer determination of EU level credit institutions supervised by other Member States.</p>
<p>4. Combination of the SRB with other buffers and timing of the measure</p>	
<p>4.1 Combination with G-SII buffers (Articles 133 (4) and (5) of the CRD)</p>	<p>In case of Hungary it is not relevant.</p>
<p>4.2 Combinations with O-SII buffers (Articles 133 (4) and (5) of the CRD)</p>	<p>O-SII buffer will be applied for identified O-SII banks from 1 January 2016 in line with the CRD and Hungarian legislation. As the SRB will be applied only for Hungarian exposures, the MNB plans to apply it cumulatively with the O-SII buffer.</p>
<p>4.3 Combined buffer requirement (Articles 133 (6) and (7) of the CRD)</p>	<p>Concerning the G-SII and O-SII buffers see answers to 4.1 and 4.2. The Financial Stability Board (FSB) of the MNB has yet to decide the CCB rate for Hungarian exposures, but the current state of the lending cycle does not warrant a rate higher than 0 per cent starting at 1 January, 2016. The size of capital conservation buffer will be set according to Section 298 of Act CCXXXVII of 2013 on Credit Institutions and Financial Enterprises, at the rate of 0,625% for 2016. As the O-SII buffer levels are yet to be decided by the Financial Stability Board, the exact level of the combined buffer requirement can be established only after both the O-SII and SRB rates are</p>

	finalised.
4.4 Timing of the measure	The general FSB decision on the SRB will be made public until mid-November 2015 with the general decision coming into force on 1 January 2016. Institution specific MNB decisions relying on data for the third quarter of 2016 will be adopted in the last quarter of 2016 according to which banks shall fulfil additional capital requirement from 1 January 2017 on a sub-consolidated level.
4.5 Review of the measure	The general decision on the SRB and the institution-specific requirements setting individual buffer rates will be reviewed annually.
5. Miscellaneous	
5.1 Publication (Article 133(16) of the CRD)	MNB plans to disclose the essential details of the SRB measure, including the general decision regarding the introduction of the buffer on its official website (www.mnb.hu) with content compatible with the CRD at around mid-November 2015. Institution specific decisions shall be published in November 2016.
5.2 Contact person(s) at notifying authority	<p>Ms. Anikó Szombati <i>Director, Macroprudential Directorate</i> Phone: +36 (1) 428 2600/1861 Email: szombatia@mnb.hu</p> <p>Mr. Péter Fáykiss <i>Head of Department, Macroprudential Policy Department</i> Phone: +36 (1) 428 2600/2239 Email: faykissp@mnb.hu</p>
5.3 Any other relevant information	The preliminary concept of the use of the SRB was accepted by the MNB FSB in September 2014. Based on this concept the MNB informed the relevant credit institutions about the details of the planned regulation and its objectives and conducted bilateral personal and written consultations with their representatives. The observances and suggestions of banks have been incorporated into the current measure, especially relating to the definition of the problem exposures, the necessity of new data reporting and the length of the phase-in period.