THE CENTRAL BANK OF HUNGARY

European Systemic Risk Board
Francesco Mazzaferro
Head of Secretariat

Germany
Frankfurt am Main
Sonnemannstrasse 22
60314

Reference No: 57868-2 /2015
Budapest, 14 April 2015

Subject: Notification of the European Systemic Risk Board (hereby ESRB) on the amendment of the requirements regarding the Foreign Exchange Funding Adequacy Ratio (FFAR) and on the regulation of the denomination consistency of the assets and liabilities of credit institutions

Dear Mr. Mazzaferro,

Hereby I would like to notify the ESRB that Magyar Nemzeti Bank (hereinafter: MNB) intends to introduce a new macroprudential regulation with the aim of regulating the currency and maturity mismatches in the balance sheets of credit institutions in Hungary. The objective of the macro-prudential regulator is to decrease the amount of short term foreign exchange funding in the Hungarian banking system following the resolution of the FX lending problem for retail mortgage holders.

The act on the conversion of retail mortgages denominated in foreign currency into Hungarian forints (HUF) took effect on 1 February, 2015. The conversion on the one hand relieves a serious macro-prudential risk in Hungary, as it eliminates the exchange rate risk of uncovered households, stemming from the foreign currency denomination of their mortgage loans. However, the sweeping changes on the asset side of the banks active on the retail market entail several risks that have to be handled in order to ensure the sustainable contribution of the banking system to economic growth. One of those risks is the HUF maturity mismatch, which is intended to be mitigated by the MNB with a special funding requirement that has already been notified to the ESRB. However, problems arise not only on the maturity side, but due to currency mismatches as well.

The current high stock of short term FX debt in the financial system poses a significant vulnerability and can amplify unintended impacts both on the economy and the financial system as well. Short term FX debt carries significant renewal and liquidity risks, and it can cause system-

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wide turbulences in money markets and unintended impacts for the monetary policy (for instance through the FX channel).

Even though the open foreign exchange position is a natural phenomenon in every bank's balance sheet, it can reach such a high level that forces banks to rely too much on the use of off-balance sheet instruments (mostly FX swaps), which poses a number of systemic risks. First of all, swaps tend to have rather too short maturities, which pose a renewal risk for financial institutions. Moreover, the margins to be deposited for the coverage of currency risk are sensitive to the FX rate movements of the Hungarian forint. In case of a substantial change in the FX rate, margin calls can cause serious liquidity issues. Margin calls are usually paid by new FX swaps resulting further influence on the FX rate, and eventually a negative spiral occurs. Lastly, overly large amounts of FX swaps may lead to higher implicit yields diminishing the effectiveness of the monetary transmission mechanism. As stated in ESRB recommendation on lending in foreign currencies (ESRB/2011/1) authorities are supposed to pay special attention to these risks stemming from the reliance on foreign markets for currency swaps.

As the conversion has not affected the liabilities side of the balance sheet of credit institutions, a pre-emptive intervention in the form of two interconnected regulatory measures is supposed to ensure that the necessary accommodation to the new situation will result in healthier and more sustainable currency mismatches. Therefore to serve this goal the Financial Stability Council deems appropriate to limit the currency and maturity mismatches in foreign currencies. This measure can also prevent serious macro-prudential risks stemming from foreign currency lending towards unhedged retail customers from arising again.

Detailed amendments

The MNB decree on the Foreign Exchange Funding Adequacy Ratio (hereinafter: FFAR) aims at simultaneously limiting maturity mismatch risks generated by long-term FX loans, and currency mismatches, as it requires that FX denominated assets are covered by either FX denominated funds or long term FX swaps. During the development of the FFAR requirements, MNB relied heavily on the actual construction of the Net Stable Funding Ratio (NSFR) originating from the Basel Committee on Banking Supervision.

At its introduction, FX swaps with maturities of over one year were accounted for as stable FX funding in the FFAR – unlike the NSFR – in order to facilitate a smooth introduction and implementation. However, besides the risks imposed by an overreliance on swaps (discussed above), the conversion of FX housing loans has made this concession superfluous, as the foreign exchange funding of the credit institutions would be abundant. That is why the former allowance to recognize over one year maturity FX swaps as long term funding would be no longer warranted. As a first step, MNB intends to implement this change to adjust the FFAR in line with applicable international standards in accordance with the ECB opinion on the current FFAR framework issued on 24 February 2014 (CON/2014/15).

In our understanding, with this move the major conceptual deviation from the stable funding principles emanating from the NSFR concept would be redressed. Some additional differences though – especially in the calibration of run-off factors – are supposed to be maintained as the availability and the stability of the same funding source denominated in FX is always weaker compared to the one denominated in local currency, so a more conservative approach is justified. Moreover, the actual ASF or the RSF factors published in the recent BCBS paper are at present international standards developed primarily for big international banking groups, whereas neither the detailed NSFR parameters nor an effectuation date is set in any binding EU regulation yet. Since the EU-specific calibration is an ongoing work under the aegis of the EBA, MNB has decided not to modify the currently binding factors, but to wait for the outcome of the EBA work and reconsider them when the final framework has been approved.

On the other hand, MNB intends to increase the expected level of coverage of long term FX denominated assets with long term FX denominated liabilities by increasing the FFAR requirement to 100% from 1 October 2015. This move intends to narrow the banking system's room for maneuver to rely on short term FX funding to nurture FX lending on an unnecessary scale.

Apart from the abovementioned changes, MNB also intends to limit the overall currency mismatch in the banking system. Although off-balance sheet items are theoretically available for closing open FX positions, several Hungarian and international cases can prove that in turbulent times markets can dry up easily and either additional margin requirements or renewal risks can make the system as a whole particularly vulnerable. Since the central bank can only be available as a lender of last resort in local currency, the over-reliance of the banking system on short term FX funding and FX swaps in a floating FX regime is a serious concern from a systemic stability point of view. To limit systemic exposure to these risks, MNB intends to introduce a new macroprudential measure. This measure would set a limit of 15% in proportion to the size of the balance sheet total for the currency mismatches between the assets and liabilities of the credit institutions. This maximum allowed level shall sufficiently mitigate risks, while it ensures on-going stable banking operations.[1] The direction of open positions would not matter, as margin requirements affect FX borrowers and FX lenders alike, should a change in the HUF exchange rate take place. Therefore, the difference between FX assets and FX liabilities would be counted in absolute value.

Amendments to the FFAR requirements

The FFAR requirement is planned to be amended in two aspects:

- Ruling out long term swap arrangements as recognized long term FX funding – as a move towards closing the gap between FFAR and NSFR standards to the extent possible.

[1] Since the beginning of 2015, open FX positions in the balance sheets of credit institutions have stayed well within the 15% boundary in relation to their balance sheet totals: more than 85% of credit institutions (both in terms of balance sheet total and number of banks) do not exceed that limit.

- Speed up the accommodation process to the 100% requirement due to the abundance of FX funding following the conversion of FX denominated mortgage loans to HUF. Indirectly, this move can ensure that the diminishing FX funding need is covered by longer term (matched) funds instead of short term FX funds, which pose systemic liquidity risks.

Regulatory limit for the currency mismatch between assets and liabilities of credit institutions

The new macro-prudential decree would require that the credit institutions adhere to a 15% limit in terms of their on-balance sheet currency mismatches. Mismatches are counted as the absolute value of the difference between the FX assets and liabilities. The ratio is related to the size of the balance sheet.

Legislative process

MNB initiated a consultation procedure with the ECB on April 9, 2015. Beforehand two rounds of consultation have been held. The MNB initiated consultation in respect of the amendment of the FFAR and of the new draft decree with the stakeholders, thereby providing an opportunity for financial institutions to offer comments and proposals. The consultation has successfully ended in April 2015. Hence, following the conclusion of the consultation procedure with the ECB, the legal wording of the decree will be approved by the Financial Stability Board of the MNB, and the decree will be published in the Official Gazette.

The proposed date of the adoption of the two MNB decrees is 1 October 2015.

Sincerely Yours:

MAGYAR NEMZETI BANK

Marton Nagy
Executive Director
Financial Stability and Lending Incentives

Enclosure - Unofficial translation of Draft Decrees (in English)

The Governor of the Magyar Nemzeti Bank

MNB Decree .../2015 (.... ....)

on the Amendment of MNB Decree 14/2014 (V.19.) regulating the maturity mismatch of foreign currency positions of credit institutions and amending MNB Decree 43/2013 (XII. 29) on the obligations of money and credit market institutions to report data to the central bank's information system primarily to enable the Magyar Nemzeti Bank to carry out its supervisory duties

Based on the authorisation specified in subsection kc) of Section 171 (1) k) of Act CXXXIX of 2013 on the Magyar Nemzeti Bank, acting within my duties set forth in Section 4 (7) of Act CXXXIX of 2013 on the Magyar Nemzeti Bank, I hereby order as follows:

1. § In MNB Decree 14/2014 (V.19.) regulating the maturity mismatch of the foreign currency positions of credit institutions and amending MNB Decree 43/2013 (XII. 29) on the obligations of money and credit market institutions to report data to the central bank's information system primarily to enable the Magyar Nemzeti Bank to carry out its supervisory duties (hereinafter: D.),

a) in Section 4 (2) the wording "on 1 January 2017" is replaced by "on 1 October 2015",

b) in Section 4 (3) c) the wording "31 December" is replaced by "30 September".

2. § (1) Section 4. (3) d) and e) of D. shall be repealed.

(2) The following sections of D. shall be repealed:

a) in section 1 of Annex 1 the wording "and the stock of net foreign currency swaps against HUF with a maturity of more than one year",

b) in section 2 of Annex 1 the wording "and the stock of net foreign currency swaps against HUF with a remaining maturity of more than one year",

c) row 11 of the table included in section 2 of Annex 1.

3. § The preliminary consultation of this draft Decree pursuant to the sixth indent of Article 2(1) of Council Decision 98/415/EC of 29 June 1998 on the consultation of the European Central Bank by national authorities regarding draft legislative provisions has been carried out.

4. § (1) This Decree – with the exception of paragraph (2) – shall enter into force on the first day following its promulgation.

(2) Section 2 (2) shall enter into force on 1 October 2015.

The Governor of the Magyar Nemzeti Bank

MNB Decree .../2015 (.... ....)

on the Regulation of the denomination consistency of the assets and liabilities of credit institutions

Based on the authorisation specified in subsection kc) of Section 171 (1) k) of Act CXXXIX of 2013 on the Magyar Nemzeti Bank, acting within my duties set forth in Section 4 (7) of Act CXXXIX of 2013 on the Magyar Nemzeti Bank, I hereby order as follows:

1. § (1). The scope of this Decree – with the exception of the stipulations in paragraph (2) – covers the credit institutions operating as incorporated companies limited by shares, and the branch offices of foreign credit institutions (hereinafter: credit institutions).

(2) The scope of this Decree does not cover:

a) Magyar Fejlesztési Bank Zrt,

b) Magyar Export-Import Bank Zrt,

c) Központi Elszámolóház és Értéktár (Budapest) Zrt, and

d) building societies.

2. § (1) The foreign exchange coverage ratio is the indicator calculated in accordance with Annex 1.

(2) The absolute value of the credit institution's foreign exchange coverage ratio must not exceed 0.15. The credit institution must comply with the requirement pertaining to the level of the foreign exchange coverage ratio at all times.

(3) In the case of groups comprising of several credit institutions subject to supervision on a consolidated basis, the group member credit institutions registered in Hungary must comply with the requirement stipulated in paragraph (2) together, on a consolidated basis.

(4) The foreign exchange coverage ratio shall be calculated on the basis of the credit institution's monthly data reporting to the Magyar Nemzeti Bank.

3. § The preliminary consultation of this draft Decree pursuant to the sixth indent of Article 2(1) of Council Decision 98/415/EC of 29 June 1998 on the consultation of the European Central Bank by national authorities regarding draft legislative provisions has been carried out.

4. § (1) This Decree shall enter into force on 1 October 2015.

Annex 1 to MNB Decree .../2015 (.... ....)

Method of calculating the foreign exchange coverage ratio

1. The foreign exchange coverage ratio is the quotient of the difference of the foreign currency assets and liabilities expressed in absolute value, and of the balance sheet total.

2. When calculating the foreign exchange coverage ratio the foreign currency assets and liabilities and the balance sheet total must be taken into account at book value.