Guidelines on methods for calculating contributions to DGSs

Public hearing, London, 8th January 2015
Outline

1. EBA and the DGSD
2. Risk based contributions: Mandate and timeline
3. Objectives
4. Necessary elements of calculation methods
5. Calculating the Aggregate Risk Weight
6. Optional elements of calculation methods
1. EBA and the new DGS Directive

- Publication date: 12.06.2014
- Transposition: 3.07.2015
  - But risk-based contributions can be postponed until 31.05.2016
  - Emergency payout: 31.05.2016
  - Full phase-in of 7 working days repayment deadline: 31.12.2023

EBA role:
- Financing:
  - Informed of level of ex-ante financing
  - Guidelines (GL) on payment commitments – Art. 10(3) DGSD
  - **GL on risk based contributions – Art. 13(3) DGSD**
    - Informed of DGS own risk based methods
    - Report on calculation models 2019
- Home-host DGS cooperation:
  - Informed of inter-DGS borrowing Art. 12(1) DGSD
  - Informed of and mediates on intra EU cooperation agreements
- Other monitoring tasks:
  - Collects information on covered deposits from MS by 31 March each year
  - Peer reviews on stress tests every 5 years
2. EBA mandate on DGS risk based contributions

Article 13(3) of the DGSD

- In order to ensure consistent application of the DGSD the EBA shall issue guidelines to specify methods for calculating contributions to DGSs

- in particular, such guidelines, shall include a calculation formula, specific indicators, risk classes for members, thresholds for risk weights assigned to specific risk classes, and other necessary elements

In line with EBA Regulation:

- « provide a high level of protection to all depositors in a harmonised framework throughout the Union”. 
Addressees of Guidelines

Designated authorities (Public DGS or supervisor of private DGS)

Competent authorities (approve own-risk based models)
2. Timeline

- **TEST**
  - Feb-April 2014

- **CONSULT**
  - ... 11 Feb 2015

- **ADOPT**
  - May 2015

- **COMPLY/EXPLAIN**
  - End 2015

- **REVIEW**
  - July 2017
3. Objectives of calculation methods

- Reach the target level
- Funding proportionate to liabilities
- Costs borne by banks
- Mitigate excessive risk
- Harmonisation & level playing field
4. Necessary elements and flexibility

- Calculation formula
- Risk categories
- Core risk indicators
- Risk factor (ARW)
- Min/max risk interval
- Weights for risk indicators
- Sliding scale v. bucketing approach
- Calibration of risk indicators
- Additional risk indicators
4.1. Calculation formula

\[ C_i = CD_i \times CR \times ARW_i \times \mu \]

Where:

- \( C_i \) = Annual contribution for institution \( i \)
- \( CD_i \) = Covered deposits for institution \( i \)
- \( ARW_i \) = Aggregate Risk Weight for institution \( i \)
- \( CR \) = Contribution rate
- \( \mu \) = Adjustment coefficient
4.2. Covered Deposits

- Article 13(1) of DGSD: ”contributions to DGSs .... shall be based on the amount of covered deposits and the degree of risk incurred by the respective member”

\[ C_i = \text{CD}_i \times \text{CR} \times \text{ARW}_i \times \mu \]
4.3. Contribution Rate

- **Contribution Rate (CR)** – percentage of its covered deposits which a bank with an average risk weight should contribute each year in order to ensure reaching the annual target level:

- Identical for all banks.

- CR = annual target level / amount of total covered deposits of the DGS members in a given year.

- Annual target level = amount to absolute target level / number of years to target (e.g. 0.08%) → spread the burden as evenly as possible.
4.4. Aggregate Risk Weight

\[ C_i = CD_i \times CR \times ARW_i \times \mu \]

- Risk factor specific for each institution’s profile
- Calculated on the basis of individual risk indicators
- ARW assigns banks to risk classes (in the bucketing approach) or determines their relative riskiness (in a siding scale approach)
- Lowest and highest ARW should vary within a range:
  - At least between 75% and 150% of average;
  - In principle within 50% and 200% of average – with exceptions.
4.5. Adjustment coefficient

\[ C_i = CD_i \times CR \times ARW_i \times \mu \]

- **Adjustment coefficient** \((\mu)\) – an additional technical parameter (applicable to all DGS members in a given year):
  - ensuring that the DGS reaches annual target level (avoiding undershooting/overshooting)
  - allowing to reflect the current business cycle in the amount of contributions paid by each DGS member
5. Calculation of the ARW in 4 steps

1. Measure
   - Indicator value 1
   - Indicator value 2
   - Indicator value 3
   - Indicator value 4

2. Rescale (IRS)
   - Individual Risk Score 1 (IRS 1)
   - IRS 2
   - IRS 3
   - IRS 4

   - ARS = weighted average of all IRSs
   - 1 < ARS < 100

3. Aggregate scores (ARS)
   - Apply ARS to buckets or sliding scale to obtain ARW
   - ARW expressed as a percentage

4. Transpose (ARW)
5.1. Step 1 – measuring risk indicators (1/3)

- **Five risk categories:**

  1. Capital
  2. Liquidity and funding
  3. Asset quality
  4. Business model and Management
  5. Potential loss for the DGS

  - Likelihood of bank’s failure
  - Potential DGS loss
5.1. Step 1 – measuring risk indicators (2/3)

- 8 core risk indicators that must be used and account for at least 75%.

- A non-exhaustive list of additional risk indicators that may be used on top to the core indicators, up to 25%.

- In exceptional circumstances, possibility to remove core indicators if not available for legal reasons

- Any additional indicator cannot, on its own, account for more than 15%, except qualitative indicators in the category Business Model and Management (e.g. IPS membership)
5.1. Step 1 – measuring risk indicators (3/3)

List of core indicators

<table>
<thead>
<tr>
<th>Risk categories and core risk indicators</th>
<th>Minimum weight</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Capital</td>
<td>18%</td>
</tr>
<tr>
<td>1.1. Leverage ratio*</td>
<td>9%</td>
</tr>
<tr>
<td>1.2. Capital coverage ratio or CET1 ratio *</td>
<td>9%</td>
</tr>
<tr>
<td>2. Liquidity and funding</td>
<td>18%</td>
</tr>
<tr>
<td>2.1. LCR*</td>
<td>9%</td>
</tr>
<tr>
<td>2.2. NSFR*</td>
<td>9%</td>
</tr>
<tr>
<td>3. Asset quality</td>
<td>13%</td>
</tr>
<tr>
<td>3.1 NPL ratio</td>
<td>13%</td>
</tr>
<tr>
<td>4. Business model and Management</td>
<td>13%</td>
</tr>
<tr>
<td>4.1. RWA / Total Assets*</td>
<td>6.5%</td>
</tr>
<tr>
<td>4.2. RoA</td>
<td>6.5%</td>
</tr>
<tr>
<td>5. Potential losses of the DGS</td>
<td>13%</td>
</tr>
<tr>
<td>5.1. Unencumbered assets / Covered deposits</td>
<td>13%</td>
</tr>
<tr>
<td>Sum</td>
<td>75%</td>
</tr>
</tbody>
</table>
5.2. Step 2 – scoring risk indicators (2/2)

- Individual Risk Scores (IRS) are used to rescale indicators’ values, into a common and comparable scale (1-100)

- An option is given to use:
  - **Bucketing approach**
    Assigning various/discrete IRSs to a range of values of an indicator
  - **Sliding scale approach**
    Each value of an indicator can be transposed into a unique IRS
5.2. Step 2 – scoring risk indicators (2/2)

- No specific thresholds for each core risk indicator

- General guidance on calibrating indicators (determining lower/upper boundaries of individual buckets, or for a sliding scale):
  - ensuring sufficient and meaningful differentiation of member institutions
  - If the bucketing approach is used:
    - at least 2 buckets for each risk indicator should be established
    - there is a choice of having buckets determined on an absolute or relative basis
  - avoid calibrating the boundaries in a way that all member institutions, despite representing significant differences in the area measured by a particular risk indicator, would be classified into the same bucket.
  - taking into account, where available, regulatory requirements applicable to the member institutions and historical data on the indicator’s values.
5.3. Step 3 – Aggregating the Individual Risk Scores

- Individual Risk Scores (IRS) for all risk indicators are multiplied by weights assigned to these indicators and summed up, via an arithmetic average, to calculate **Aggregate Risk Score (ARS)** ranging from 1-100.

\[ ARS_i = \sum_{j=1}^{n} IW_j * IRS_j \]
5.4. Step 4 - the Aggregate Risk Weight (ARW)

- The ARS is transposed, by using a sliding scale approach or a bucketing approach, into an **Aggregate Risk Weight (ARW)** ranging from 50% to 200%

![ARS to ARW conversion diagram]

Bucketing approach

Sliding scale approach
6. Optional elements of calculation methods

- Incorporating into the calculation method options and national discretions given to Member States in the DGS Directive

**Minimum contributions**
- Fixed fee in addition to risk-based contributions, OR
- Minimum fee instead of the risk-based contribution (if the risk-based contribution is lower than the minimum fee)

**IPS membership**
- To be reflected in “Business model and Management” (≤25%)
- If IPS not recognised as a DGS: decreasing the member’s ARW to reflect the additional solvency and liquidity protection provided by the scheme to the member (funding of IPS / TA of member)
- If IPS recognised as a DGS: increasing the ARW for central entities

**Low-risk sectors**
- Reflected in the category “Business model and Management”
- Regulated under national law
- Regulation reduces likelihood of failure
- Empirical evidence that occurrence of failure is consistently lower
Conclusion

Sound harmonised minimum formula for risk-based contributions

- Will reach the target level in time while respecting the business cycle
- Will contribute to risk discipline
- Will ensure a level playing field in the internal market

Respects variety of business models and national banking sectors

- Flexibility on criteria, scoring, intervals

Respects national options foreseen by the Directive