

8. Assessment of risks to capital

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Outline

1. General overview
2. Main risk categories
3. Assessment methodology
4. Scoring system. Risks scores
5. Major innovations in the risk assessment framework
 - FX lending risk. Materiality
 - Market risk definition
 - IRRBB
 - Emphasis on conduct risk
 - Treatment of model risk

General overview

Assessment of risks to capital

What it is about:

- Understanding the impact that individual risks may have on an institution using all available sources of information.

What we did:

- Develop a methodology very much based on supervisory judgment to assess and score the most significant material risks faced by banking institutions.

What we did not:

- Develop complex models to quantify individual risks
- Analyse whether individual risks are adequately cover with own funds (capital adequacy)

Main risks categories

- Mapping of the main categories and sub-categories faced by banking institutions.
- CRD IV risks classification and definitions were the starting point but SREP GLs did not always stick to this approach (e.g. Equity exposures).

Credit and counterparty risk:	Market risk	Operational risk.	IRR from non-trading activities	Others
<ul style="list-style-type: none"> - Concentration - Counterparty and settlement - Securitisations - FX lending - Specialised lending 	<ul style="list-style-type: none"> - Position risk - Foreign-exchange risk. - Commodities risk - CVA risk - Credit spread risk - Equity exposures. 	<ul style="list-style-type: none"> - Conduct risk - Systems- ICT risk - Model risk 	<ul style="list-style-type: none"> - Re-pricing risk - Yield-curve risk - Basis risk - Option risk 	<ul style="list-style-type: none"> - Pension risk - Insurance risk - Structural FX risk.

- The college may agree upon:
 - Different sub-categories breakdowns when relevant for a banking group.
 - Material sub-categories to be assessed and scored separately. No guidance established for defining materiality except for FX lending risk.

Assessment methodology

Assessment methodology provided for most common material risks faced by institutions: Credit and Counterparty risk, Market risk, Operational risk, IRR from non-trading activities.

Assessment of inherent risk:

- Broad methodology based on best practices of competent authorities. Room for supervisory judgement.
- No specific quantitative indicators prescribed, although we expect that these are identified by competent authorities.
- Identify main drivers for each specific material risk.
- Role of internal and supervisory Stress Test



Assessment of management and controls:

- Supervisors to determine if management and controls are 'fit for purpose'.
- Common steps for all risks:
 - Risk strategy and appetite
 - Organisational framework
 - Policies and procedures
 - Risk identification, measurement, management and reporting,
 - Internal control framework
- Role of the internal stress tests.



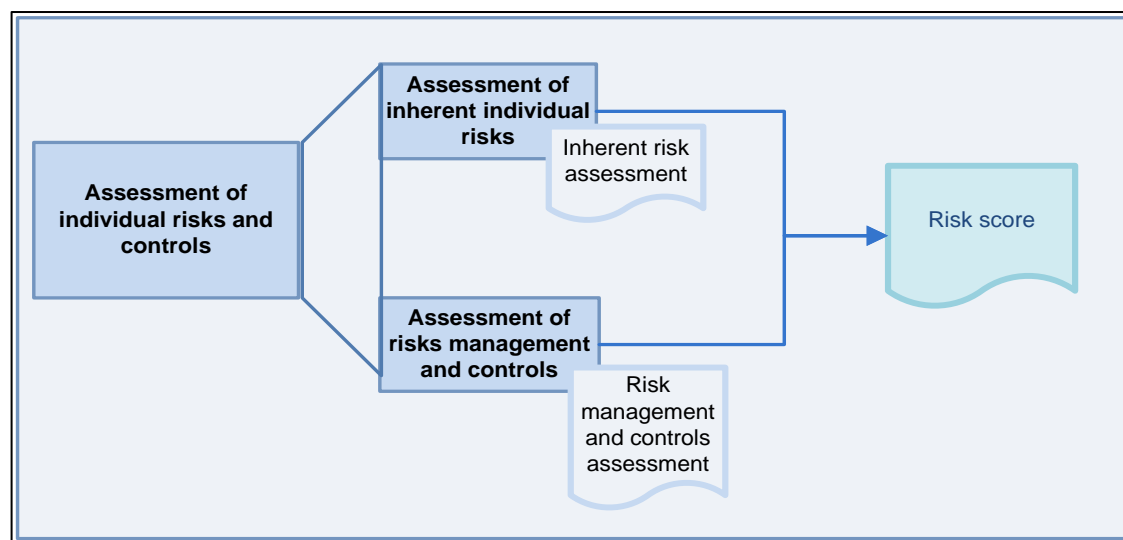
The outcome of the assessment reflected in:

Summary of the findings

Score

Scoring system. Risks scores

- **What do SREP GLs score?** individual risks to capital (credit, market, operational...).
- **Purpose of the score:** common language for comparison and communication purposes; not direct link with the need to take supervisory measures or to request additional capital.
- **Meaning:** indication of the level of risk assumed by an institution.
- **How:**
 - Supervisory judgement constrained by some basic considerations.
 - Predominately based on the level of inherent risk but also reflecting the adequacy of risk management and controls which may increase or, exceptionally, decrease the level of inherent risk.



Scoring system. e.g. credit risk

Risk score	Supervisory view	Considerations for inherent risk	Considerations for adequate management & controls
1	There is no discernible risk of significant prudential impact on the institution having considered the level of inherent risk and the management and controls.	<ul style="list-style-type: none"> The nature and composition of credit risk exposure implies non-material risk. Exposure to complex products and transactions is not material. The level of credit risk concentration is not material. The level of forborne and non-performing exposures is not material. Credit risk of performing exposures is not material. The coverage of provisions and of credit valuation adjustments is very high. Coverage and quality of guarantees and collateral is very high. 	<ul style="list-style-type: none"> There is consistency between the institution's credit risk policy and strategy and its overall strategy and risk appetite.
2	There is a low risk of significant prudential impact on the institution having considered the level of inherent risk and the management and controls.	<ul style="list-style-type: none"> The nature and composition of credit risk exposure implies low risk. Exposure to complex products and transactions is low. The level of credit risk concentration is low. The level of forborne and non-performing exposures is low. The credit risk from performing exposures is low. The coverage of provisions and of credit valuation adjustments is high. Coverage and quality of guarantees and collateral is high. 	<ul style="list-style-type: none"> The organisational framework for credit risk is robust with clear responsibilities and a clear separation of tasks between risk takers and management and control functions.
3	There is a medium risk of significant prudential impact on the institution having considered the level of inherent risk and the management and controls.	<ul style="list-style-type: none"> The nature and composition of credit risk exposure implies medium risk. Exposure to complex products and transactions is medium. The level of credit risk concentration is medium. The level of forborne and non-performing exposures is medium. The credit risk from performing exposures is medium and subject to further deterioration under stress conditions. The coverage of provisions and of credit valuation adjustments is medium. Coverage and quality of guarantees and collateral is medium. 	<ul style="list-style-type: none"> Credit risk measurement monitoring and reporting systems are appropriate. Internal limits and the control framework for credit risk are sound.
4	There is a high risk of significant prudential impact on the institution having considered the level of inherent risk and the management and controls.	<ul style="list-style-type: none"> The nature and composition of credit risk exposure implies high risk. Exposure to complex products and transactions is high. The level of credit risk concentration is high. The level of forborne and non-performing exposures is high. The credit risk from performing exposures is high. The coverage of provisions and of credit valuation adjustments is low. Coverage and quality of guarantees and collateral is low. 	<ul style="list-style-type: none"> Limits allowing mitigating or limiting the credit risk are in line with the institution's credit risk management strategy and risk appetite.

Scoring system. e.g credit risk

International banking group: credit risk assessment and score

Inherent risk:

- The loan portfolio accounts for 65% of the institution's total assets. RWA for credit risk represent 74% of the institution's total RWA.
- Loans to corporates represent 55% of the loan portfolio, the remaining 45% are loans to retail customers.
- Corporate loans are well diversified geographically, by sectors and single name. The retail portfolio is also well diversified by geographical regions.
- NPL stand at 2.4%, with a coverage ratio of 60%. These two ratios have remained stable for the last 3-4 years.

Management and controls:

- Management and controls have been found adequate to the institution's risk profile with no major deficiencies identified.

Score

2

- Some significant deficiencies have been found. The institution does not have:

- Systems in place to identified groups of connected clients.
- Limits by sectors of activity.
- Adequate system to identify and monitor forborne exposures.

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Major innovations in the risk assessment framework

FX lending risk. Materiality.

EBA GLs on capital measures for foreign currency lending: **Repealed from January 2016**

- Most of the significant aspects of those GLs are now stated in the SREP GLs under the credit risk methodology. However, others, such as the proposed capital measures, disappear.

Materiality definition is left to supervisory judgement, except for FX lending risk.

- FX lending risk, materiality threshold:

Loans denominated in FX to unhedged borrowers constitute at least 10% of and institution's total loan book (total loans to non-financial corporations and households), where such total loan book constitutes at least 25% of the institution's total assets.

Consequences of triggering the FX materiality threshold:

- Institutions are expected to address this risk separately in their ICAAP.
- Supervisors are expected to assess and score this risk separately in the SREP.
- Supervisors should determine the additional own funds needed to cover this exposure (title 7).

Major innovations in the risk assessment framework

FX lending risk. Materiality

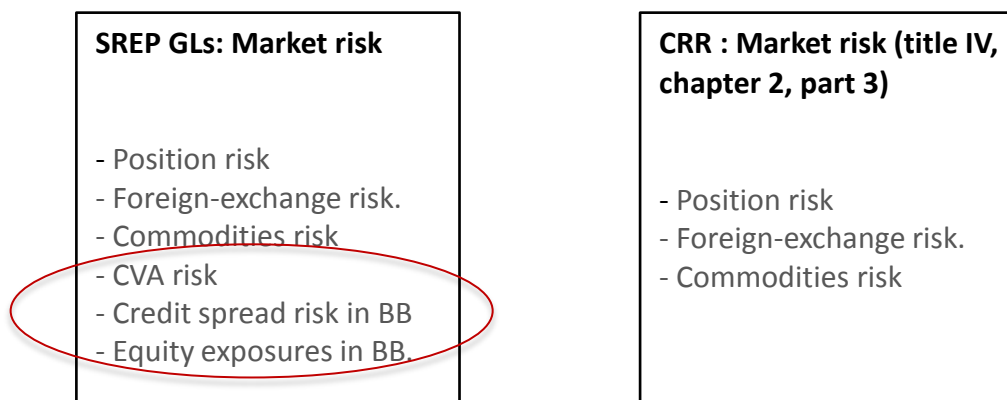
SREP elements		Score
A.	Business Model (viability and sustainability)	
B.	Internal governance arrangements	
C.	Risks to solvency	
C.1	Credit and counterparty risk	
C.3	FX Lending risk	
C.4	Market risk	
C.5	IRRBB	
C.6	Operational risk	
C.8	Other risks material to the institution, as applicable (please specify)	
C.9	Other risks material to the institution, as applicable (please specify)	
D.	Risks to liquidity	[as per the outcome of the Liquidity SREP report] These scores should be consistent with the respective assessments under the liquidity joint decision. Depending on the timing of the joint decision on liquidity, this assessment should either mirror the findings summarised in the liquidity SREP report, or provide updated assessment.
E.	Systemic risk (risk that institution poses to financial system)	
Overall SREP Score		

SREP elements		Memoranda items		Overall SREP capital requirement/estimate (including supervisory proxy, where applicable) (in mln EUR)
		Pillar 1 capital requirements, where applicable (in mln EUR)	ICAAP estimate (in mln EUR)	
A.	Business Model (viability and sustainability)			
B.	Internal governance arrangements			
C.	Risks to solvency (risks and controls)			
C.1	Credit and counterparty risk			
C.3	FX lending risk			
C.4	Market risk			
C.5	IRRBB			
C.6	Operational risk			
C.8	Other risks material to the institution, as applicable (please specify)			
C.9	Other risks material to the institution, as applicable (please specify)			
D.	Risks to liquidity -Funding risk (cost of funding perspective)			
E.	Systemic risk (risk that institution poses to financial system)			
F.	Inter-risk diversification effects			
G.	Capital planning / stress test buffer (where applicable)		Capital planning / Stress testing buffer based on the outcomes of ICAAP stress tests, where applicable	Reconciliation of ICAAP stress tests with supervisory stress tests and resulting capital planning / stress testing buffer, where applicable
SREP capital outcome (preliminary proposal for joint decision discussion)				
H.	Overall capital requirement/estimate	Total Pillar 1 capital requirement	Total ICAAP capital estimate	Total SREP capital estimate
	Capital adequacy assessment (capital is assessed as adequate/inadequate)			Adequate/Inadequate
	Additional own funds requirement			Sum of components or holistic approach (formulated as an amount or ratio, or combination of both)

Major innovations in the risk assessment framework

Market risk definition

Are SREP GLs creating a new market risk definition?



- CVA risk, credit spread risk and equity exposures have a mixed nature.
- Could they be assessed separately as an individual risk category?
 - Yes, if they are material and this is agreed in the college
- Could they be assessed under a different risk category (e.g. credit risk)?
 - Yes, if this is agreed in the college

Major innovations in the risk assessment framework IRRBB.

Starting point: Updated version of EBA GLs on interest rate risk arising from non-trading activities under the SREP (oct-2006):

- Principles addressed to supervisors.
- Principles addressed to institutions.

SREP GL: Risks to capital (title 6)

Methodology for assessing IRRBB:

- Based on the principles address to supervisors, SREP GLs establish a general framework for assessing IRRBB.
- SREP GLs do not set out how to determine additional capital requirements for IRRBB.

GLs on interest rate risk arising from non-trading activities.

- New version published on 22 May 2015.
- Only principles addressed to institutions.
- General guidance on how to identify and mitigate IRRBB.

Major innovations in the risk assessment framework

Emphasis on conduct risk

- Sub-category of operational risk
- Very broad scope in terms of events
Focus is given to inappropriate provision of financial services but actual scope can be broader (e.g. money-laundering, etc.)
- Very broad range of losses and effects
(e.g. fines, redress costs, market bans, economic losses, reputational damage, etc.), potentially disruptive on individual financial institutions and on markets

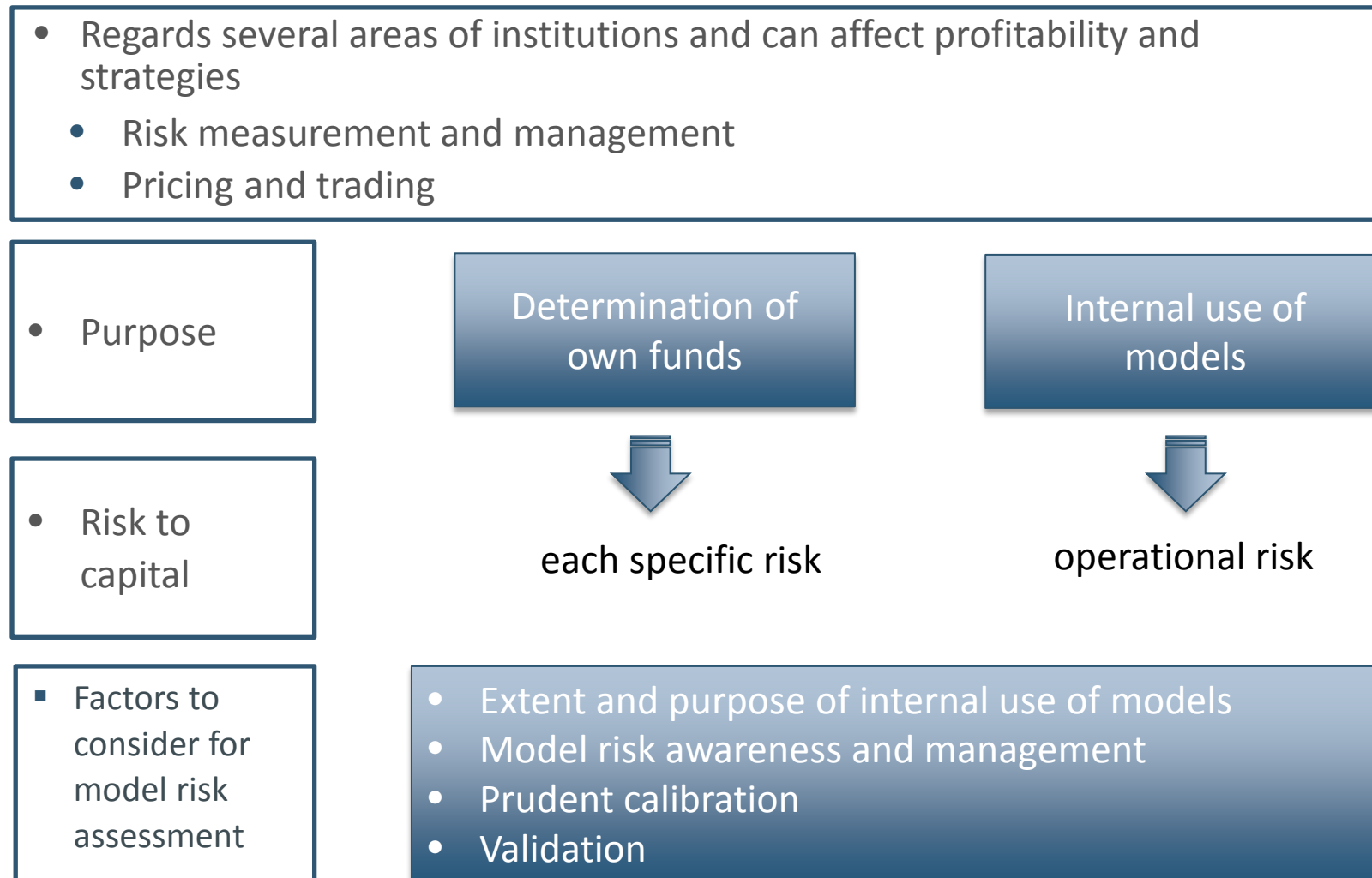
Possible areas of supervision

- **Degree and diffusion of risk culture** (e.g. training provided, discussion of risks at Board level and embedment in internal policies)
- **Business plans and incentive policies** (e.g. short term volume targets vs. long term risk/return targets, neutral vs. internal pricing/fee policies etc.)
- **Complaints records and management** (e.g. trends, settlements)
- **External economic and regulatory environment** (e.g. regulatory crackdown on some practices in some regions)
- **Others** (e.g. organisational arrangements: independence between support/control functions and front-office functions; quality and frequency of internal controls; etc.)

Operational risks are, more than all the others, connected to the quality of internal controls and risk management as well as with the level of risk culture throughout the organisation

Major innovations in the risk assessment framework

Treatment of model risk





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