

11. Case study on the assessment of capital adequacy

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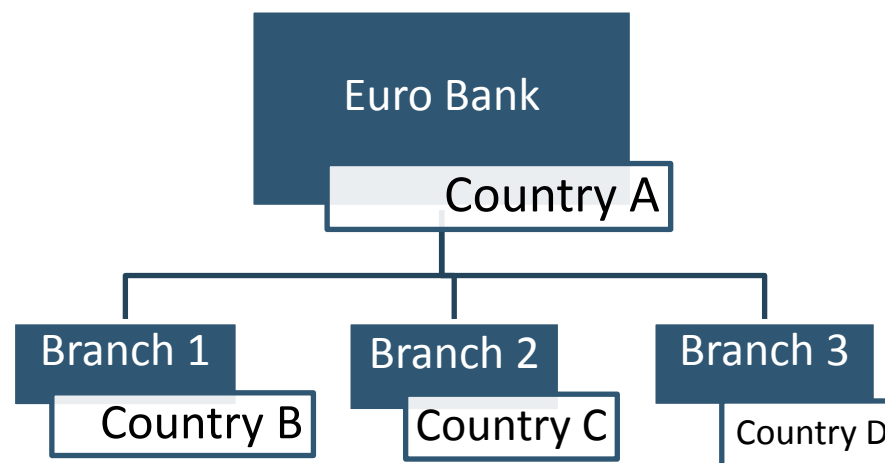
Objective

Analysing and discussing key elements of capital adequacy assessment

- Determination of additional own funds
- Interaction between micro and macro prudential requirements
- Use of stress test in SREP
- Capital requirements articulation

The discussion will be based on a simplified representation of a hypothetical institution

Euro Bank: overview



Business model

Retail bank providing mortgages and supporting import/export business in main partner countries.
Trading activity limited to non-complex instruments and driven by customer needs

Country A

- 2 year recession
- Rise in Interest rates
- Rise in unemployment
- Rise in default rates
- Drop of Real Estate market

Supervisory info

Systemic Importance

Category 1; O-SII

Solvency ratios

CET 1: 8% ; TCR: 12%

Combined buffer

Capital conservation buffer: 1%

O-SII: 1%

SRB:1%

Simplified Balance sheet

	Assets		Liabilities	
Trading Book	Government bonds	10	Deposits from customers	60
Banking Book	Interbank loans	15		
	Loans to customers	55		
	of which:		Central Bank	10
	<i>retail mortgages</i>	25	Interbank loans	10
	<i>consumer revolving loans</i>	5	Non eligible debt instruments	11.8
	<i>other retail loans</i>	3	Tier 1 debt issues	3
	<i>corporate loans</i>	22		
	Cash	10		
	Other assets	10	Equity	5.2
Total		100		100

Includes real
estate
developers

P&L	
NIM	5
Fees	1
Costs	-3.5
Credit losses	-1.5
Op losses	-0.5
EBT	0.5
Net profits	0.25

Credit Quality

Total loans	70
Impaired loans	8
of which NPL	7

(nominal amount 10)



Concentration on Real Estate sector

Low coverage ratio 30% of NPL

Material credit and operational losses

Cost\Income

Risk assessment

Business focused on lending to retail customers, which are now being hit by the economic slowdown. Short term strategy aimed at increasing exposure to highly rated SMEs operating with foreign counterparties (sector with high competition) and consumer revolving loans (highly risky). Cost /income ratio above peers. **Score 3**

Sound **internal governance** and control system, but struggling with embedding risk appetite (in particular operational risk) in business decisions. **Score 3**

The bank's book has experienced a **material deterioration of credit quality** due to prolonged recession which led to a material increase of the NPL ratio (to 15% of total loans to customers). The **coverage ratio (30%) is lower than peers** in Country A (45% on average)

High exposure concentration to real estate sector (retail mortgages and real estate developers) 50% of the loans. Observed increase of **exposure to risky consumer revolving loans**. **Score 4**

Operational risk losses are on the rise due to litigation costs and redressing of customers' losses for wrong advisory on investments (+300% YoY). The number of outstanding customer complaints has increased. The bank has reviewed its product catalogue and is undertaking a massive review of customers' profiles for a more consistent offer starting from the next months. **Score 4**

Market and IRRB risks are present but not significant. **Score 1**

No other material risks identified.

Capital adequacy assessment

Risk	Includes credit concentration		Supervisory Benchmarks	Includes lower provisions
	Pillar 1	ICAAP		
Credit	4.8	4	6.12	ICAAP not deemed overall reliable, since based on too optimistic assumptions and not reflecting actual credit and operational risk
Market	0.02	0.02	0.02	
Operational	0.375	0.375	0.8	
IRRBB	0	0.1	0.1	
Concentration	0	0	0.6	
Systemic risk	0	0	0.5	
Sum	5.20	4.50	8.14	
<i>Diversification</i>	0.00	-0.50	-0.50	
Total	5.20	4.00	7.64	

Add-ons	CET1	T1	TSCR ratio
Lower credit provisions	0.50		TREA 65
Credit (model risk)	0.46	0.36	CET1 (4.5% + CET1 add-ons/TREA) 7.0%
Concentration	0.60		Min T1 (max(6%; CET1 + T1 add-ons)) 8.9%
Oprisk	0.25	0.55	TCR (max(8%; CET1 + all add-ons)) 8.9%
IRRBB		0.10	
Systemic risk	0.30	0.22	OCR
Diversification	-0.50		Combined buffer (CB) 3.0%
Total	1.61	1.23	CET1 (CET1 + CB) 10.0%

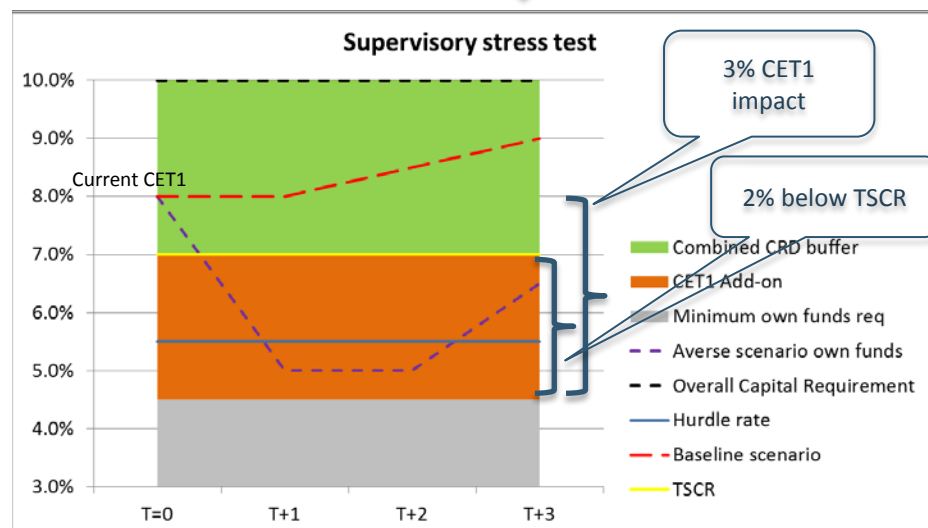
CET1 7% at all times

TCR 12% (in line with current levels)

Capital plan to ensure 7% CET1 is not breached under stress (i.e. 2% buffer)

Dividend restriction to restore Combined buffer

Capital severely affected under adverse scenario, with CET1 below hurdle rate (5.5%)



Discussion among participants

- Taking in mind the provisions of EBA SREP guidelines, participants should determine whether the assessment conducted by the competent authority in the example and the measures are consistent and appropriate
- In particular, participants should focus on:
 - The determination of the additional own funds
 - Are all risks considered?
 - Is the Pillar 1+ approach applied?
 - The determination and articulation of the TSCR
 - Is the quality and composition of own funds adequate?
 - The use of stress test outcome
 - Are measures adopted consistent with the risks revealed by ST?
 - The interaction between micro and macro supervisory measures
 - Are there any overlapping measures?

The order of the topics follows the steps taken in the previous page

Focus more on concepts rather than figures (but figures may help sometimes)



Capital adequacy assessment

Not covered by risk assessment

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Overlapping with SRB and O-SII

ICAAP not deemed overall reliable, since based on too optimistic assumptions and not reflecting actual credit and operational risk

Diversification not consistent with Pillar 1 + approach

Not sufficient to maintain capital above 7%

CET1 7% at all times

TCR 12% (in line with current levels)

Capital plan to ensure 7% CET1 is not breached under stress (i.e. 2% buffer)

Dividend restriction to restore Combined buffer

Capital severely affected under adverse scenario, with CET1 below hurdle rate (5.5%)

OCR has not been reported

Capital plan (e.g. stress test buffer) overlapping with capital conservation buffer and combined buffer

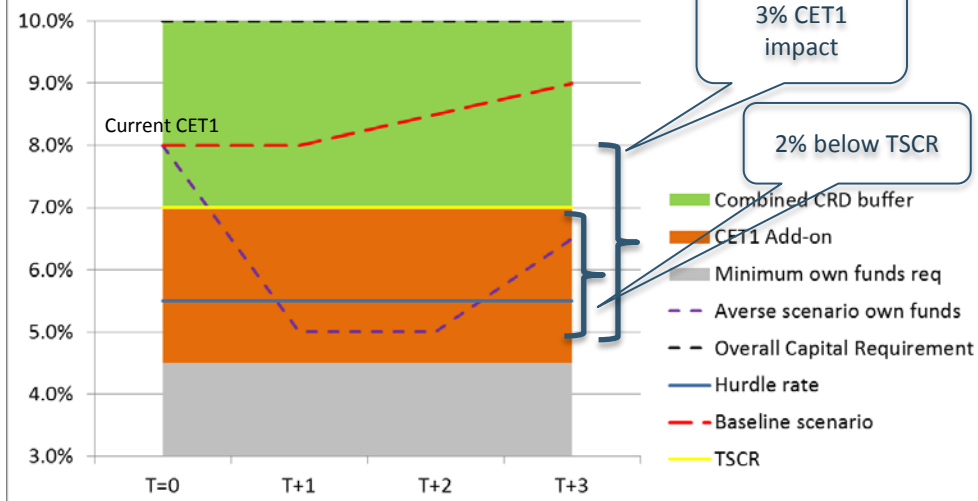
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Total	1.61	1.23	

Non in line with minimum composition requirement: at least 56% CET1

Lower provisions could have been also addressed by review of provisioning

Calculation does not follow SREP GL: First you determine specific add-ons, then arrive to TSCR and then decide on the quality of capital needed

Supervisory stress test



What is the capital adequacy score





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