

Ambasciata d'Italia a Mosca

Capital Buffers: Calculating Risk Profiles and Governance – The Banca d'Italia Experience

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SOCHI 2013 ASROS ANNUAL BANKING CONFERENCE The coordination problem in Europe-The response: SSM

- The work to create a single supervisor in the euro-area, consisting of the ECB and the national authorities is proceeding expeditiously. Starting outfrom the national authorities' store of technical knowledge, the newinstitution will have to ensure a supranational vision based on best practices in supervisory methodologies, modelling and assessment of banking risks.
- The transition to the single supervisory mechanism will give stability to the euro area, helping to counter the trend towards the segmentation of the financial markets along national lines, which we have seen during the crisis.
- It will facilitate comparisons between the banks and systems of the different countries.

The coordination problem in Europe-The response: SSM

- On 20 June the Eurogroup reached an agreement on the possibility of using the resources of the European Stability Mechanism (ESM) to recapitalize banks directly under certain stringent conditions for a maximum of up to €60 billion.
- This will be conditional on the launch of the single supervisory mechanism, which in turn will have to be preceded by a balance sheet assessment of the banks subject to centralized supervision at European level and, in particular, by an asset quality review.

The coordination problem in

Europe-The response: SSM

- The agreements reached are an important step towards banking union but they do not break the vicious circle between the conditions of sovereigns and banks or eliminate the fragmentation of financial markets along national lines.
- A European resolution mechanism must be created as soon as possible, based on a single resolution authority and pooled resources, able to cope with systemic crises and prevent contagion

Capital Buffers: Why

- With the benefit of hindsight, we now know that the cushions accumulated in the run-up to the crisis (capital buffers, liquidity reserves) were too small, so that when the crisis erupted there was little that policymakers could do in the way of releasing instruments in a countercyclical fashion.
 - Response: to increase quality and quantity of capital

Basel III

• Basel 3 is the most significant result achieved so far by international authorities. Even though the regulatory process has not yet come to a close, the direction of the reform is clear enough: more capital and liquidity for financial institutions, less leverage in their balance sheet, more instruments to mitigate the potential procyclical effects of regulation, and a balanced and somehow innovative interaction between microprudential and macroprudential rules. Moreover, the cornerstones of the current regulatory paradigm (i.e. risks ensitivity, three-pillar approach, range of alternative methods for banks to compute capital requirements) have been maintained.

Basel III

• As regards the definition of capital, the new regulation aims at raising the quality of banks' capital base by means of stricter criteria for the eligibility of common equity Tier 1 (CET1) instruments. The main idea is that common shares and retained earnings must represent the predominant form of regulatory capital; also, the treatment of deductions has been harmonized across jurisdictions by detailing the items to be deducted and the capital layers from which the deductions must be made.

Banks' capital in Italy

- Over the last few difficult years the Italian banking system has strengthened its capital base considerably. Banks' ability to withstand adverse shocks has improved.
- The increase in high-quality capital needed to satisfy the capital adequacy requirements envisaged by the Basel III rules that will be phased in by 2019, which was €35 billion at the end of 2010, dropped below €9 billion last December;
- already today most of the largest intermediaries would meet the new prudential requirements.

Banks' capital in Italy



Source: Consolidated supervisory reports.

Capital Buffers and BIII

- Capital Buffers:
 - Macro prudential instrument
 - Micro prudential instrument

- Macroprudential policy should aim to contain systemic risk. However, this is by no means a univocal statement of objectives, as systemic risk has multiple facets, and defies clear measurement. Even the usual distinction between the cross-sectional dimension and the time-series dimension of systemic risk, although conceptually important, does not provide an operational definition of the objective of MAP policy.
- Second, MAP policies have important interactions with other policies, such as monetary and fiscal policy, and microprudential policy. Yet, these interactions are largely unexplored.
- Third, selected MAP instruments seem to have some effectiveness. However, the experience gathered thus far on the use of these instruments is still limited, and refers largely to developing economies.

- In response to the financial crisis, the international community has agreed on new instruments designed to address the time and cross-sectional dimensions of systemic risk.
- Concerning the time-dimension of systemic risk, the Basel III framework puts in place three elements to address procyclicality:
- 1) a maximum leverage ratio;
- 2) a capital conservation buffer;
- 3) a countercyclical capital buffer.

 Capital Conservation Buffer is designed to curb the discretionary distribution of earnings (or bonuses) if banks' capital ratios fall below predefined target ratios

 Countercyclical buffer – a truly macroprudential tool – shall be activated only when aggregate credit growth is judged to be associated with the build-up of system-wide risks and switched off during normal times.

In both the build-up and release phase of the buffer, the exercise of judgment remains critical. Implementation features specifically address the potential for crossborder spillovers and arbitrage: the jurisdictional reciprocity principle is designed to protect banks from credit cycles outside the home country, and addresses incentive challenges to circumvention. It represents an important step towards achieving a better coordination between home and host authorities in the deployment of macroprudential tools, and might serve as a model for international coordination of macroprudential policies more generally.

Concerning the cross-sectional dimension of systemic risk, the policy development on critical parts of the FSB's framework to address the risks posed by SIFIs has been finalised.

It includes: (i) a methodology for assessing the global systemic importance of banks based on five broad sets of indicators (size, interconnectedness, lack of substitutes, cross-jurisdictional activity and complexity); (ii) additional loss absorbency capacity for banks that is in line with the degree of global systemic importance; (iii) a new international standard for resolution regimes and additional measures to improve the authorities' capacity to resolve SIFIs; and (iv) measures for more intensive and effective supervision

Given that they seek to limit the systemic risk posed by SIFIs, some elements of the SIFI framework can be thought of as **macroprudential tools**. These include the **additional loss absorbency requirements for systemic institutions** and the potential deployment by supervisory authorities of measures to address overly complex organizational structures based on resolvability assessments and the feasibility of recovery and resolution plans. In addition, the framework can serve as a useful starting point for dealing with domestic systemically important financial institutions.

Dynamic Provisioning: the Spanish experience

Spain introduced dynamic provisioning unrelated to specific bank loan losses in 2000 and modified its formula parameters in 2005 and 2008. In each case, individual banks were impacted differently. The resultant bank-specific shocks to capital buffers, coupled with comprehensive bank-, firm-, loan-, and loan applicationlevel data, showed some impact on the supply of credit and on real activity. Academic Estimates showed that countercyclical dynamic provisioning smoothed cycles in the supply of credit and in bad times upheld firm financing and performance.

The Joint Risk Assessment

A cooperative puzzle solving



The Joint Risk Assessment

- **1.** The Home supervisor needs the contribution of host supervisors to get a full picture of the banking group
- 2. Host supervisors cannot fully understand the entities under their supervision, without knowing the home supervisor's assessment of the group
- **3.** There is, in principle, a convergence of interest between home and host supervisors

The JRAD in a nutshell



The JRAD in a nutshell



The JRAD in a nutshell



Figure 1. Overview of the process for the joint assessment and decision on risk-based capital adequacy



The Joint Risk Assessment

- The JRA translates the assessment of the technical situation of individual and consolidated entities into a common format and metrics.
- Catch: even if the reporting format and the metrics are the same, methodologies may be (and actually are) very different.
- <u>An effort towards convergence in</u> <u>approaches and tools is still necessary.</u>

The Joint Risk Assessment

The Joint Risk Assessment on capital levels should be the outcome of a constructive dialogue among college members



The Common decísion on capital level





The Common decísion on capital level

The synthesis of the process should be the request for Consolidated Capital consistent with:

- the Joint Risk Assessment outcome
- the capital levels set for every component the group
- the distribution of risk



The Common decísion on capital level

The Joint Decision should cover the adequacy of the consolidated level of own funds held by the group with respect to its financial situation and risk profile, as well as the required level of own funds above the regulatory minimum, applied to each entity within the group.

The Joint Risk Assessment and the calculation of capital add-ons/buffers



Lessons learnt in the first years of the JRAD: insufficient discussion and sub-optimal decisions;
methodologies for calculating the capital add-ons far from homogenous.

A common accepted good practice has not emerged yet.

The Joint Risk Assessment and the calculation of capital add-ons



There are significant differences in the way supervisors factor the ICAAP in the SREP:

- a pivotal factor
- one of a number of factors
- a minor component

Calculating the capital add-ons: Different approaches

Ordinal Approach:

Groups are ordered following an ordinal scale, according to their final SREP assessment. Each bucket corresponds to a minimum TIER 1 capital ratio (i.e. a Pillar II requirement).

Quantitative Approach:

Each group is assigned the "desired" level of capital to be held (including possible addons) through a supervisory formula. Discretional/ judgmental approach:

The amount of capital add-ons is decided discretionally by the supervisors on the basis of qualitative considerations

The Common decision on capital level



The Common decísion on capital level: an example of insufficient coordination

In principle there should be consistency between a bottom-up approach and a consolidated approach.

In practice, insufficient coordination may lead to sub-optimal capital allocation.



The Common decision on capital level: What could the issues be?

Every host supervisor, especially following the crisis, has a self interest to ask for more capital at subsidiary level.

Anecdotal evidence shows that requests for additional capital at subsidiary level are not always borne out by data analysis and may be not consistent with the "common" view at consolidated level. The Common decision on capital level: What could the issues be?

The risk: a run to ask for more capital and a subsequent sub-optimal situation for the group.

A possible solution:

- 1) closer coordination both on consolidated and on solo/individual decisions
- 2) closer links between the capital add-on requests and supervisory assessments.



Línking capital add-ons requests to the supervisory assessment

The starting point is the comparison between SREP and ICAAP results (building block approach)

X Bank – Capital requirements



Línking capital add-ons requests to the supervisory assessment





Línking capital add-ons requests to the supervisory assessment

A Target/Trigger Ratio: the target /trigger ratio is computed by comparing the SREP Capital measure with Pillar I RWA (with the Tier 1 Ratio being set at an appropriate percentage of the Total Capital Ratio)

RWA	SREP Total Capital Requirements
200	26,5
Total Capital Ratio	13,3%
Tier 1 Ratio	10,7%

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Línking capital add-ons requests to the supervisory assessment: the target ratio



Línking capital add-ons request to the supervisory assessment: the trigger ratio



The Determination of the adequate levels of own funds at the group and entities levels: other practical issues

Lack of consistency of the capital add-on requests:

- in some cases only Core Tier-1 Capital
- in other cases Tier-1 Capital
- in other cases Tier-1 and Total Capital

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Thank You!