



Capital Add-ons: Calculating Risk Profiles and Governance

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Banking and Financial Supervision

ESE Conference

Luxembourg, 29 September 2011

The Joint Risk Assessment

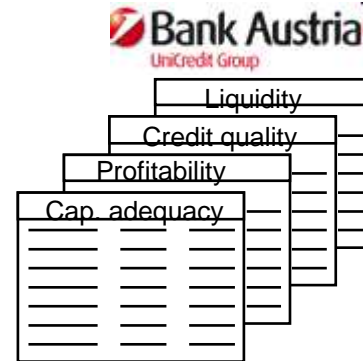
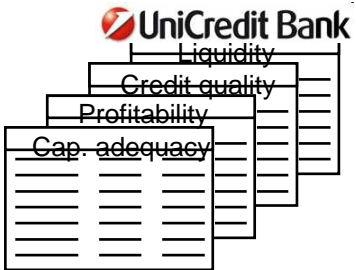
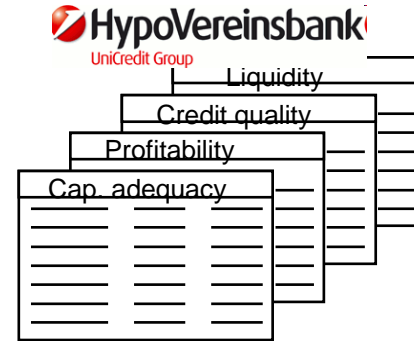
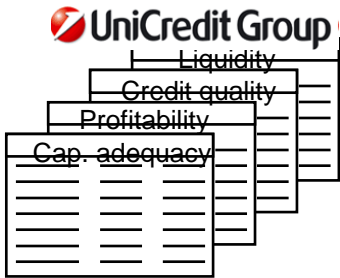
A cooperative puzzle solving



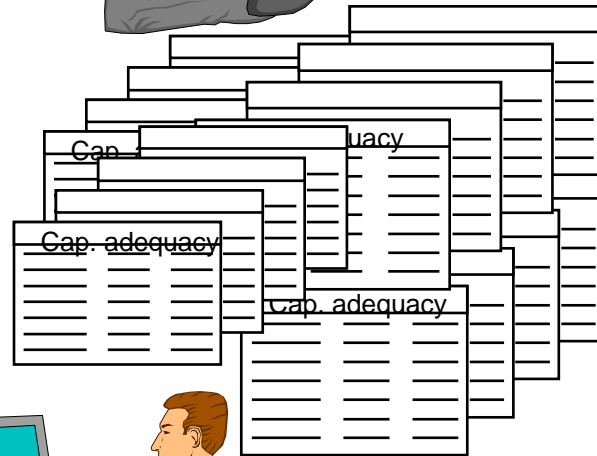
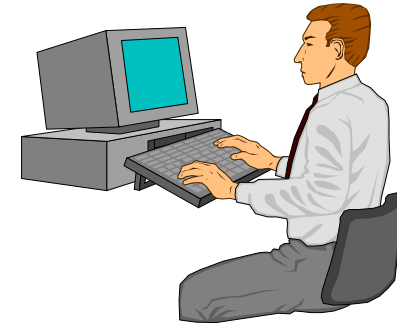
The Joint Risk Assessment

- 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**

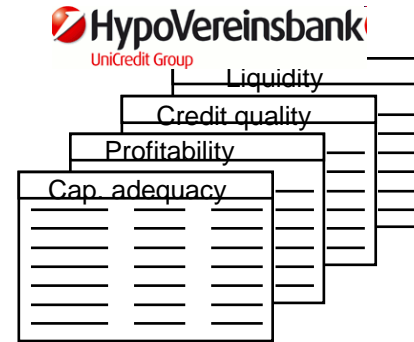
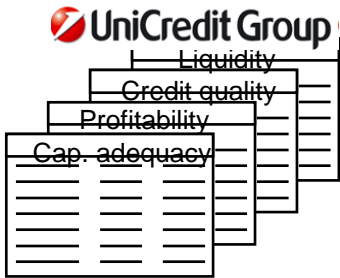
The JRAD in a nutshell



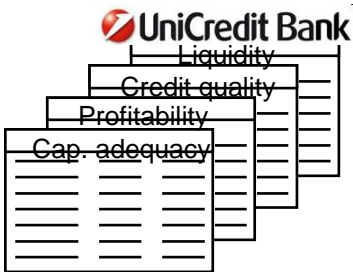
The JRAD in a nutshell



The JRAD in a nutshell



1. Uniform template for drafting the Risk Assessment Reports



2. Different "calculation engines"

3. Common ratios??

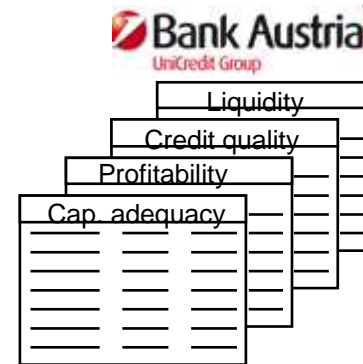
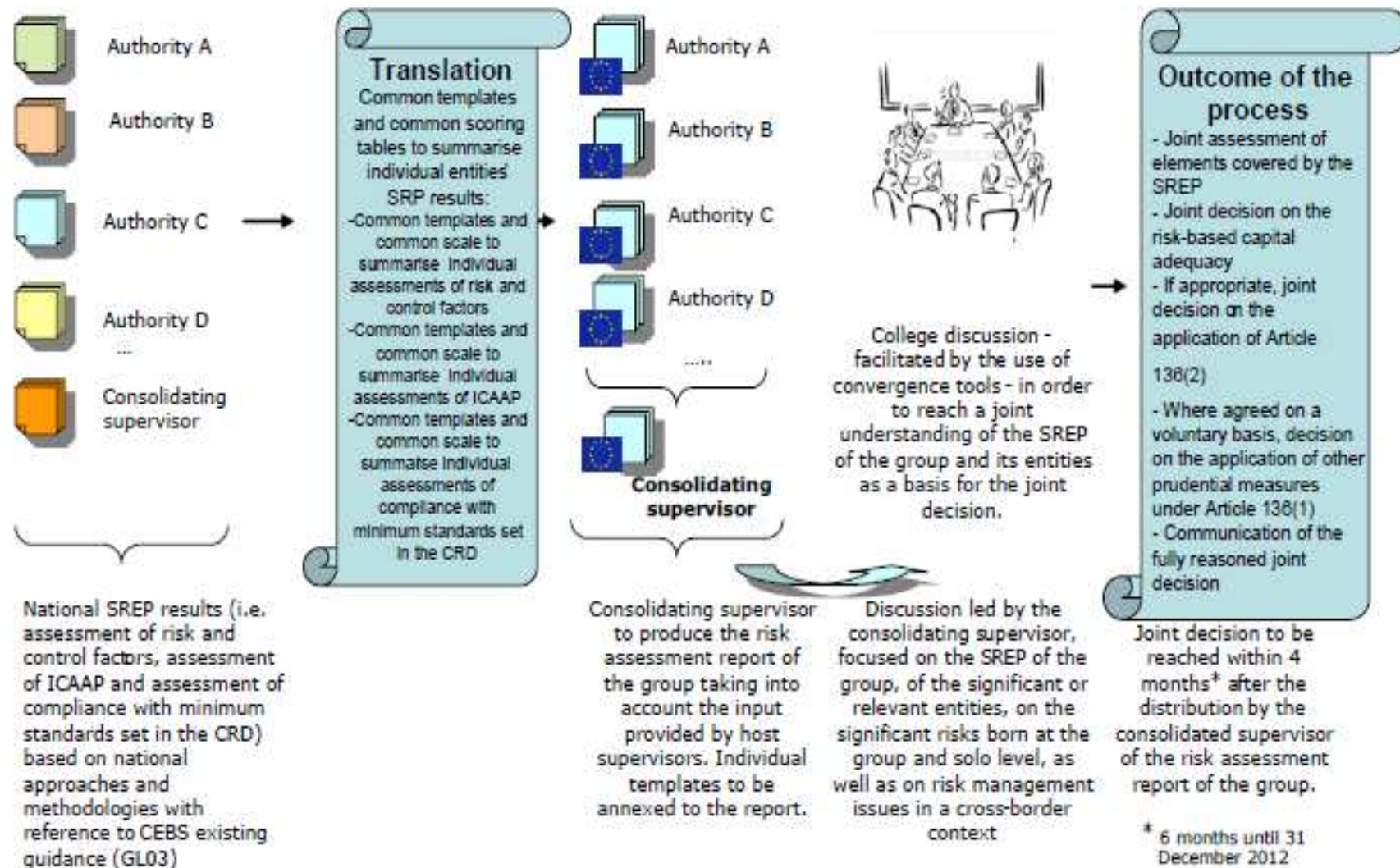


Figure 1. Overview of the process for the joint assessment and decision on risk-based capital adequacy



The Joint Risk Assessment

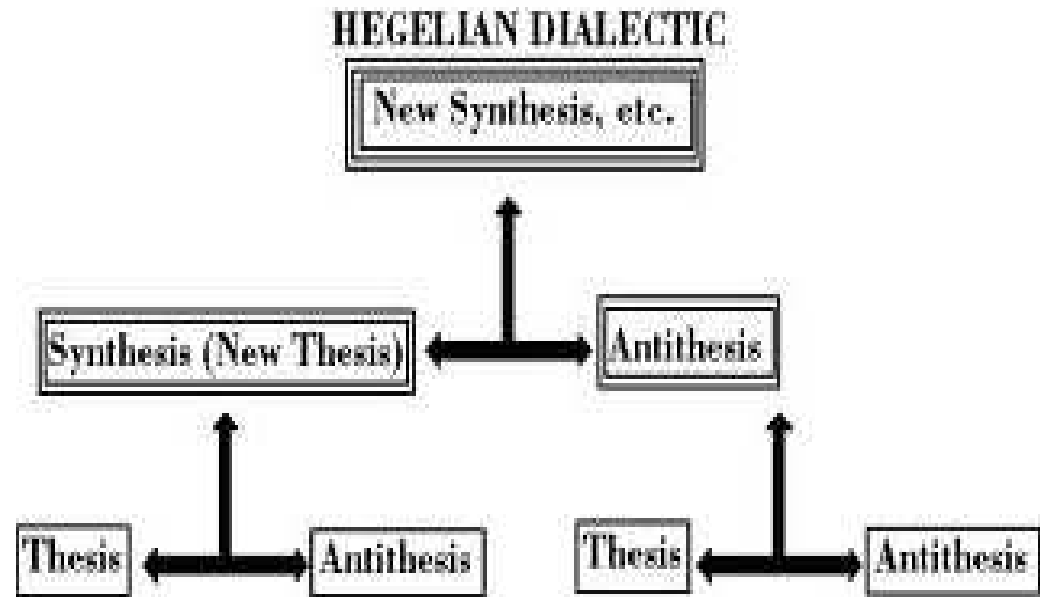
- **The JRA translates the assessment of the technical situation of individual and consolidated entities into a common format and metrics.**
- **Catch:** even if the reporting format and the metrics are the same, methodologies may be (and actually are) very different.
- **An effort towards convergence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

The Joint Risk Assessment

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



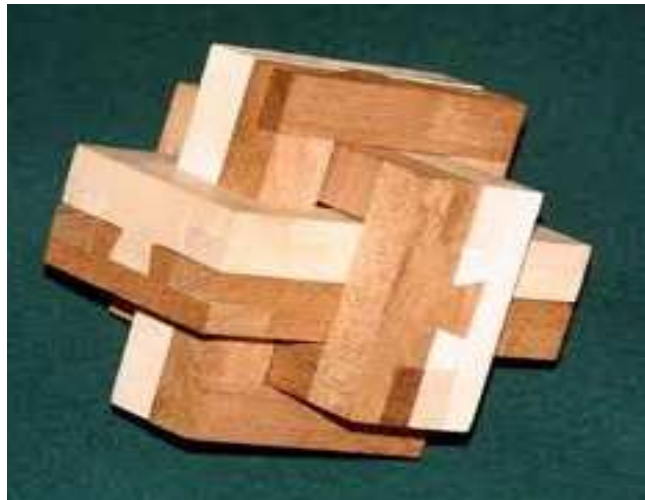
The Common decision on capital level



The Common decision 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 decision 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



Lessons learnt in the first year 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 add-ons) through a supervisory formula.

Discretionary/ 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 decision on capital level: an example of insufficient coordination

	CT1	RWA	CT1R (actual)	Minimum Requirement	Surplus/ Deficit	New minimun	Implied RWA	New CT1R
Parent	30,0	100,0	30,0%	7%	23,0	8,0%	114,3	26,3%
Sub A	20,0	100,0	20,0%	7%	13,0	15,0%	214,3	9,3%
Sub B	7,0	50,0	14,0%	7%	3,5	12,0%	85,7	8,2%
Sub C	2,0	20,0	10,0%	7%	0,6	10,0%	28,6	7,0%
Group	30,0	270,0	11,1%	7%	11,1	9,0%	347,1	8,6%



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Group Bottom Up							442,9	6,8%



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

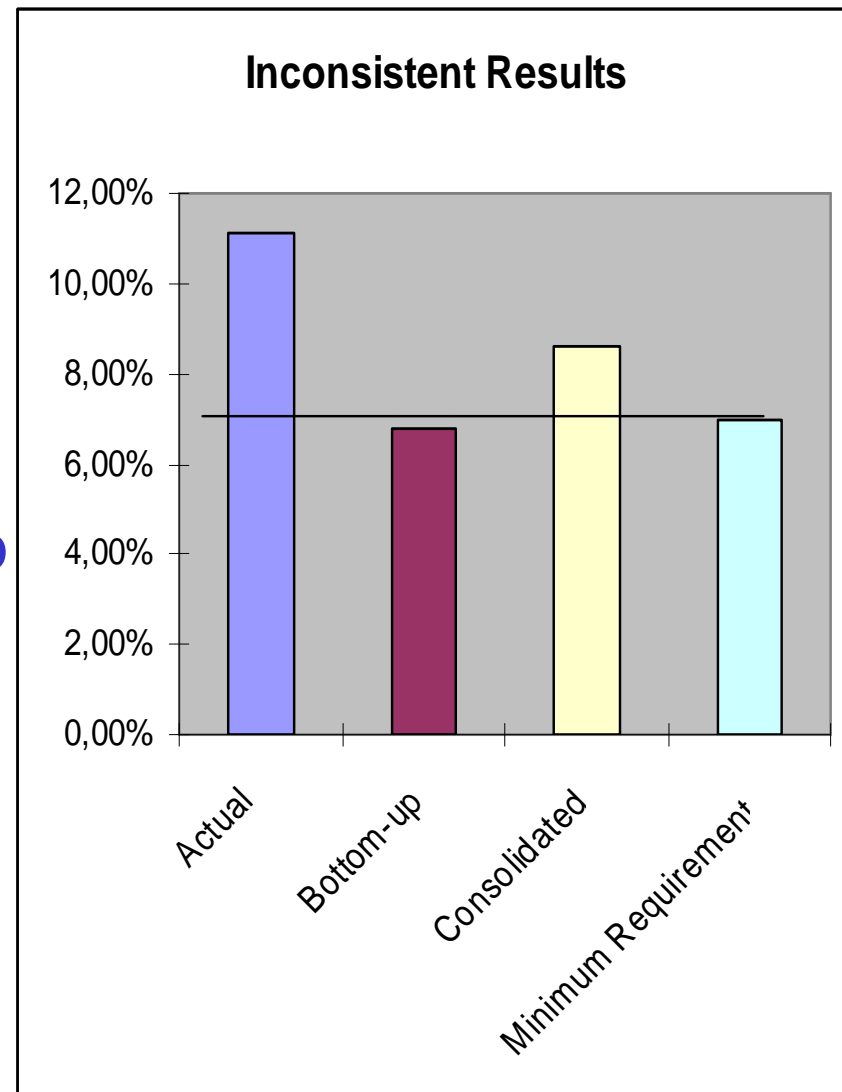
	CT1	RWA	CT1R (actual)	Min. Req.	Surplus / New Deficit	New minimum	CT1 - Required
Parent	30	100	30,0%	7%	23	8%	8
Sub A	20	100	20,0%	7%	13	15%	15
Sub B	7	50	14,0%	7%	3,5	12%	6
Sub C	2	20	10,0%	7%	0,6	10%	2
Group	30	270	11,1%	7%	11,1	9%	24,3
Group Bottom Up							31



The Common decision 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?

“In the end it was decided that 3/4 of the water should go to the peasants and 3/4 should go to the Impresario”

From *Fontamara*, by Ignazio Silone, 1930.

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

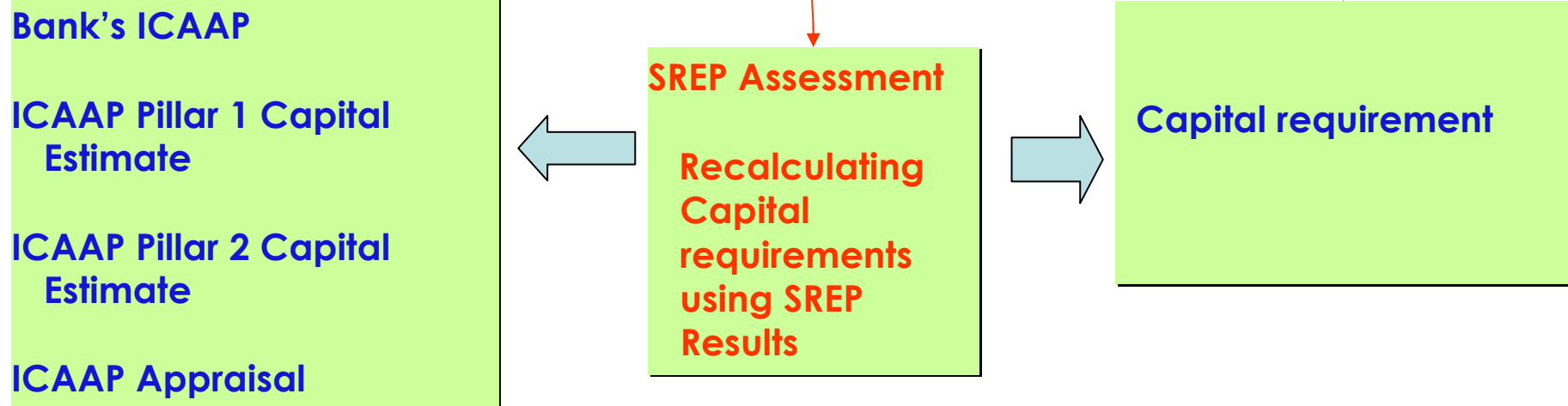
The risk: a run to ask for more capital and a subsequent sub-optimal situation for the group.

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.**

Linking capital add-ons requests to the supervisory assessment

Calculating the capital add-ons



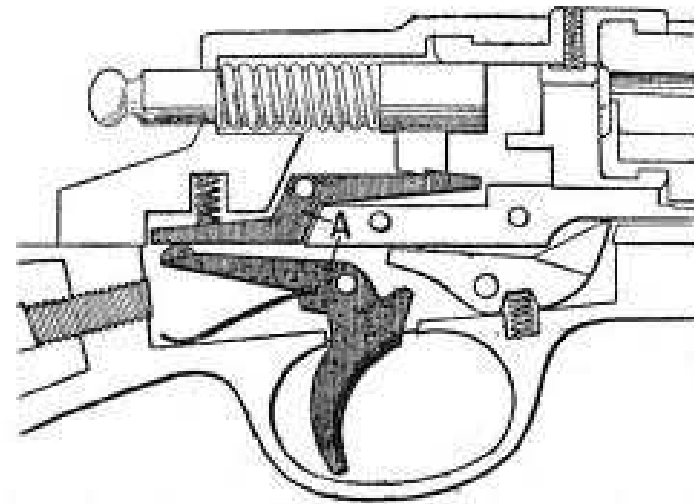
Linking capital add-ons requests to the supervisory assessment

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

X Bank – Capital requirements

	ICAAP figures	SREP results
Risks		
Pillar I Risks	9	15,5
Pillar II Risks	4	11
Total Capital	13	26,5

Linking capital add-ons requests to the supervisory assessment

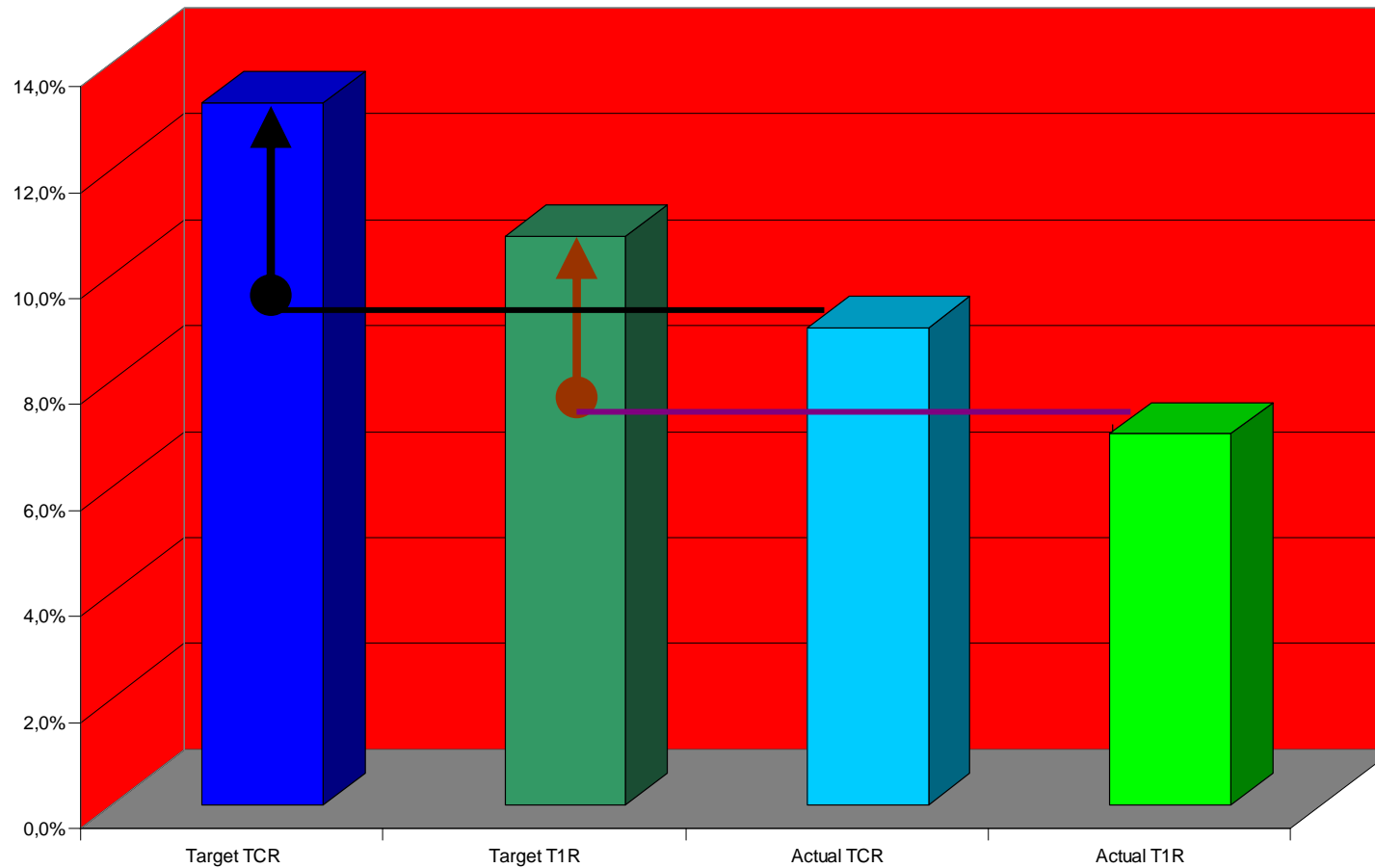


Linking capital add-ons requests to the supervisory assessment

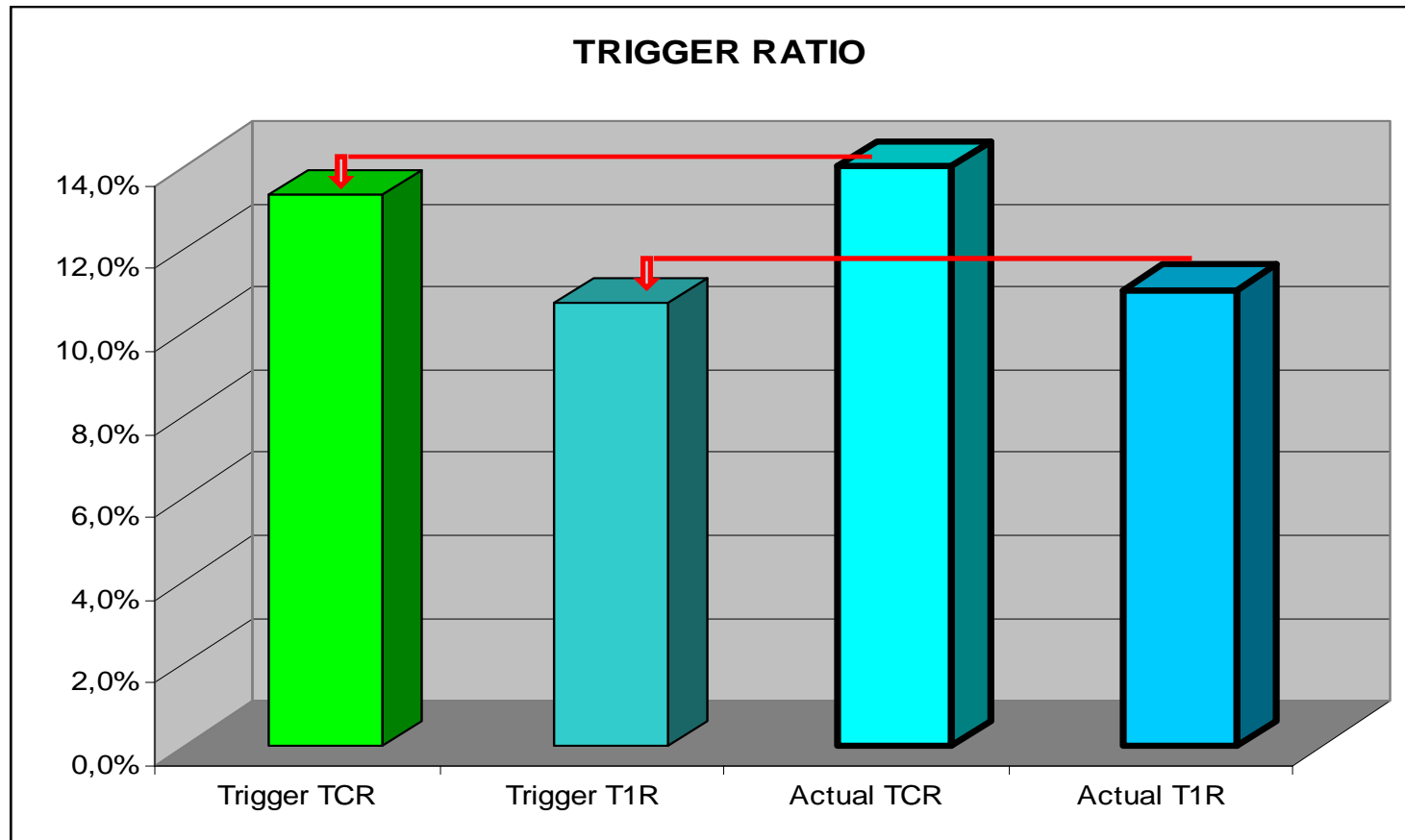
A Target/Trigger Ratio: the target /trigger ratio is computed by comparing the SREP Capital measure with Pillar I RWA (with the Tier 1 Ratio being set at an appropriate percentage of the Total Capital Ratio)

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

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



Linking 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**

Thank You!