G.E.B.

Groupement Européen de Banques

RWA based measures and DGS contribution

10 February 2015

Unlevel playing field between IRB and standardized approach for credit risk.

Citing the consultation paper “a high ratio RWA/TA signals an institution engages in risky activities”. This rationale is only applicable for IRB banks. Under standardized approach riskweights are higher and do not reflect the underlying risk. We support different calibration rules for institutions that calculate their capital requirements for credit risk using the standardised method to counter this distortion.

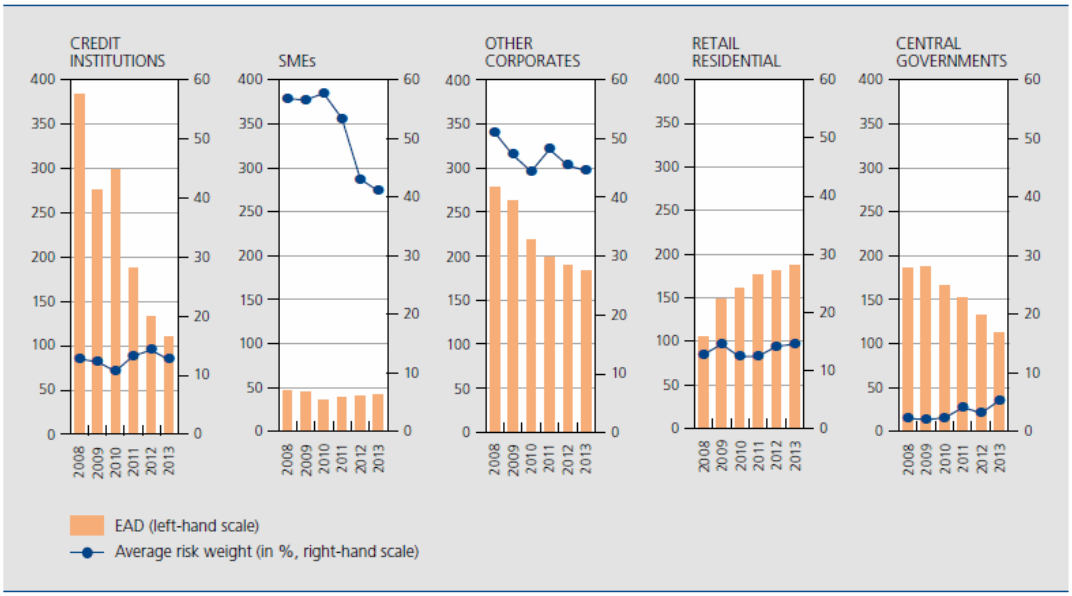
Mismatch between internal rating based models and the standardized risk approach

Risk weighting assets might be advantageous to banks that have the scale to develop efficient internal rating based models.

Especially in member states where loan losses remain at low levels the difference between the results of internal models and the standardized risk weight can be substantial.
In Belgium for instance the National Bank published the average risk weights of the IRB approach as per 31/12/2013.

CHART 27 EXPOSURES AT DEFAULT AND AVERAGE RISK WEIGHT FOR SOME ASSET CLASSES FALLING WITHIN THE IRB APPROACHES OF THE PILLAR I CAPITAL REQUIREMENTS FOR CREDIT RISK

(consolidated end-of-period data, in € billion, unless otherwise stated)



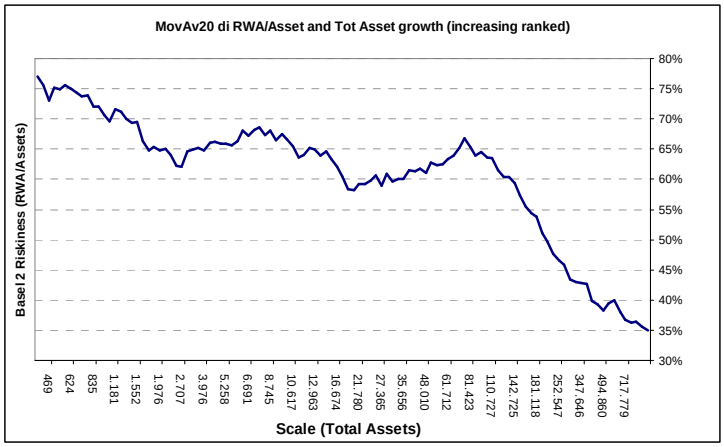
Source: NBB.

- For SME credits the average IRB risk weight is at 42%, where the standardized approach imposes 75%
- For corporate credits the average IRB risk weight is at 45%, where the standardized approach imposes 100%
- For retail residential mortgages the average IRB risk weight is at 15%, where the standardized approach imposes 35%.

Using risk weighting of assets to determine the solvency, asset quality or risk-adjusted profitability that should reflect the risk based contributions credit institutions have to pay, results in an unlevel playing field between larger advanced-IRB institutions and smaller institutions that lack the scale to develop internal models and therefore use the standardized approach.

Other research shows that there is a strong inverse relation between the scale of an institution and RWA. This correlation can be easily seen in the following graph

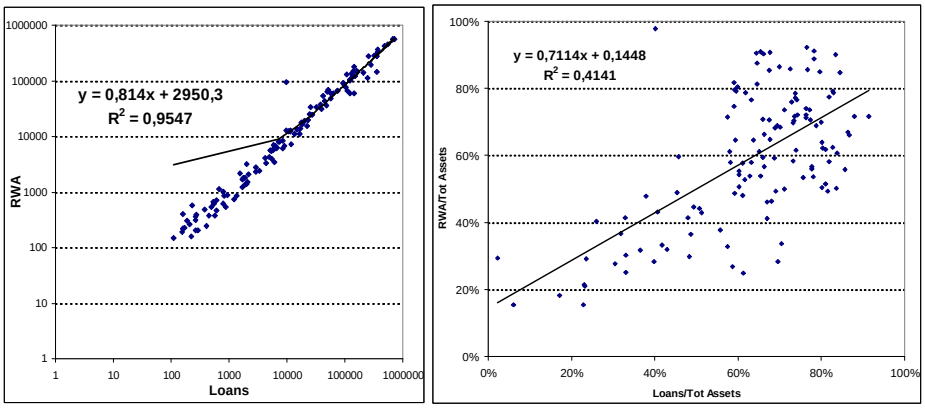
(referred to 2009 data) where a growing bank scale (measured as total assets) appears to be inversely related to risk (calculated as RWA/assets).



Source: Gruppo Banca Sella

Being this the case, considering a higher RWA/Total Asset as a direct measure of risk, creates a disadvantage to smaller institutions, called for a proportionally higher contribution even if they don't receive a direct benefit from the fund.

The strong inverse relation between the scale and RWA can be linked to the direct relation between the presence of loans and RWA (below). So the more lending (loans) oriented is a bank, the more RWA it has in this framework: *lending equals risk* in Basel2 framework. More advanced risk models probably allow a less strong correlation between loans and RWA (see graph on the right)[1].



Source: Gruppo Banca Sella

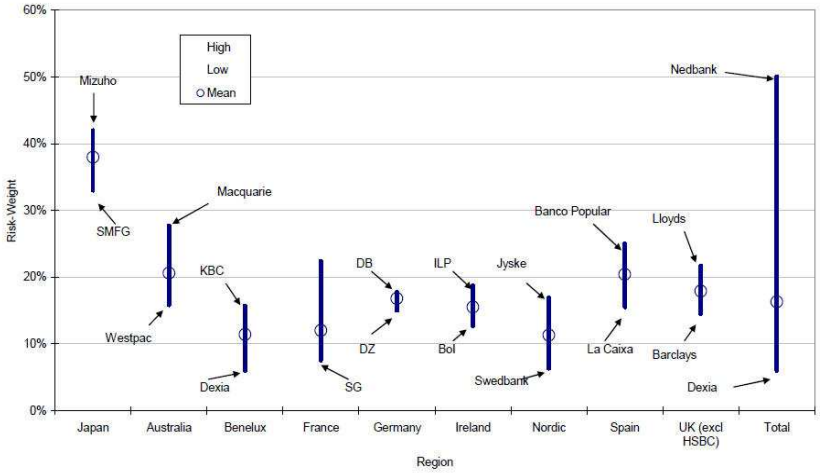
<u>IRB-models determining the level of risk-based contributions create a disadvantage for institutions that use a more conservative model approach</u>

Several studies have demonstrated that the results of internal risk weighting models differ greatly between institutions.

Research has been carried out by Standard & Poor's in which the results of risk weighting models were compared between institutions that are active in the same country. This research shows that these risk weights differ greatly from one another.

[1] The higher dispersion in the right hand graph shows that, independently of bank dimensions, lending oriented banks (with large loans to asset ratios) can have a low RWA to asset ratio, probably through more advanced risk models. The higher costs and complexity of these models makes them more suitable for large banks.

Mortgage exposure risk weight range by country under the IRB approach

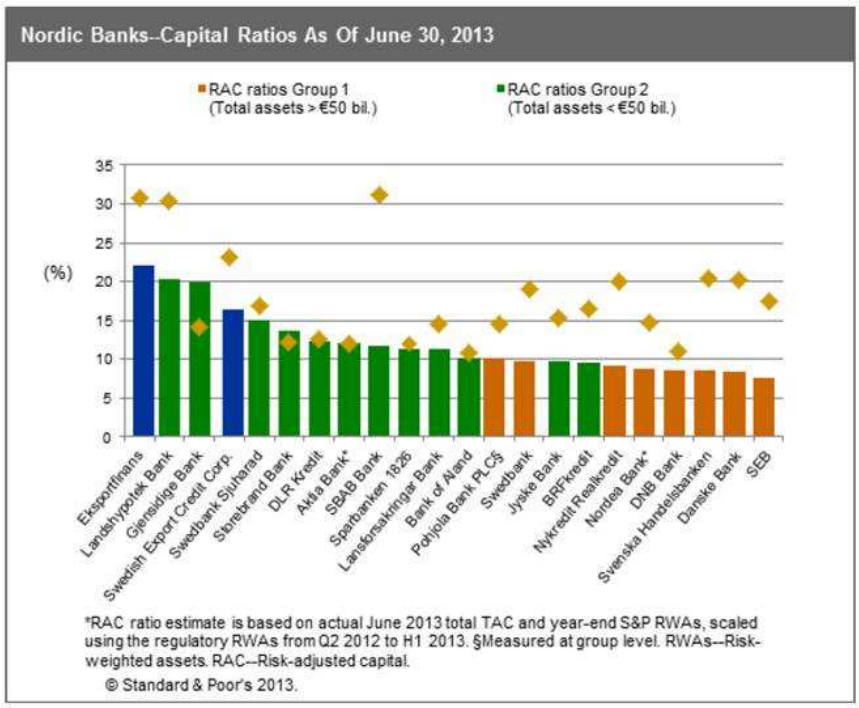


S&P Approach To Bank's Capital Adequacy' Elie Hériard Dubreuil, copyright Standard & Poor's 2009, reproduced with permission of Standard & Poor's Financial Services LLC

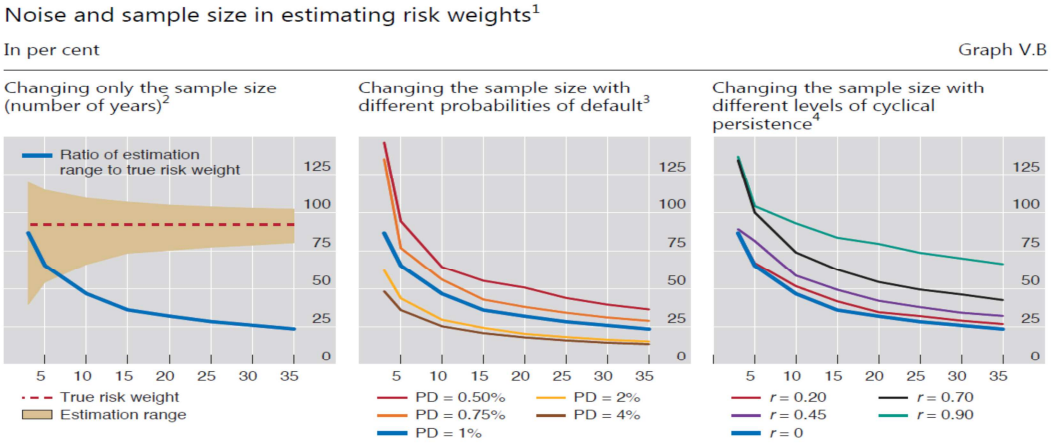
A possible explanation for the significant differentiation in risk weights could be that the institutions concerned are niche players targeting a specific mortgage market segment with a lower or higher than average risk profile. However this is not the case since only institutions with a dominant market position were included in the analysis, so that it can be assumed that their credit portfolio must reflect the mortgage market in which they are active as a whole. As a consequence of this the different risk weight results can only be explained by differences in the risk model. This variability is also recognized bij the Basel Committee on Banking Supervision in a.o. the paper, Reducing excessive variability in banks' regulatory capital ratios (A report to the G20-November 2014). As noted in the Committee's recent report to the G20 Leaders, the Committee is taking steps to reduce the level of observed variation in capital ratios across banks. Meanwhile, the unlevel playing field has not been evened out yet and the further application risks causing more imbalances.

More recently Standard & Poors compared the Capital Ratios of Nordic Banks based on the regulatory RWAs with their proper calculation based on "S&P-RWA's. As the underlying chart shows, for several institutions there are substantial differences.

Chart 1



When the use of internal risk models whose results differ greatly from one another would be is taken into account to determine risk based contributions, the normal working of the market would be disrupted.
More recently, the BIS has clearly shown in its annual 2013 report[2] that the noise (variance across estimates) in estimating the risk weights through IRB models can reach unsustainable levels (even 4/5 of the true value) in circumstances which are not exceptional (for instance a length of the historical period used for estimation under 15 years or a loan portfolio with PSs lower than 1%).



[1] Risk weights are computed on the basis of the Basel framework's internal ratings-based approach for credit risk for a given probability of default (PD). [2] Estimation based on cyclical persistence, *r* (measured as the year-on-year serial correlation of the systematic risk factor) = 0 and PD = 1%. [3] *r* = 0. [4] PD = 1%.

Source: BIS calculations.

We support the counterbalance for RWA/TA with loss absorbing capability measures like cyclically adjusted Return on Asset and Credit Risk Adjusted Interest Income (or

[2] http://www.bis.org/publ/arpdf/ar2013e5.pdf

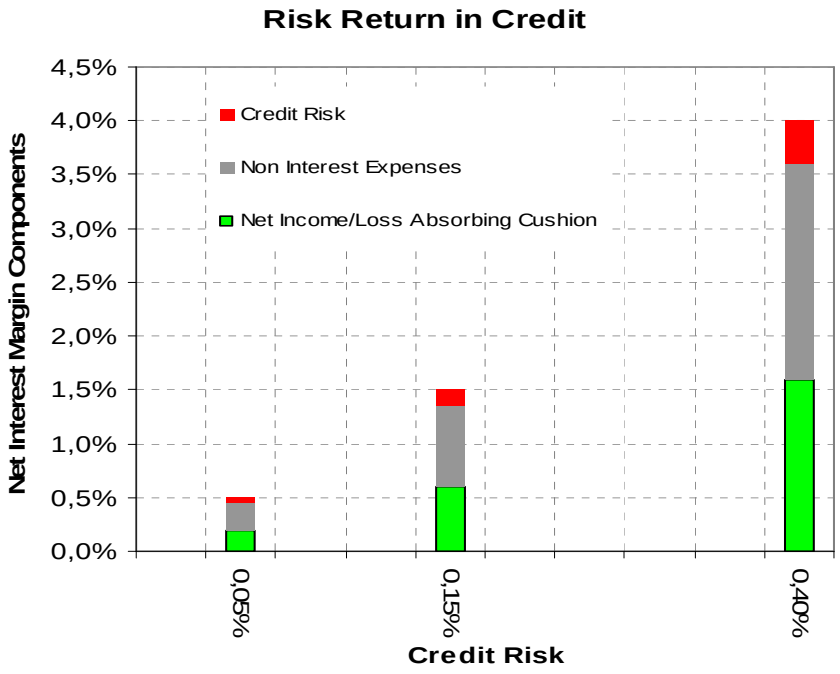
margin). In our opinion, this last measure addresses the backward looking fashion of measures like NPL/Loans and asset quality is better assessed if they are used together.

To further clarify our position:

Determining the asset quality of a credit portfolio by risk costs (NPL) neglects other important parameters, as the following example shows. Which business model is the most risky?

- A portfolio of residential mortgages with a spread of 0,50% and average risk costs of 0,05%
- A portfolio of SME credits with a spread of 1,50% and average risk costs of 0,15%
- A portfolio of personal loans with a spread of 4,00% and average risk costs of 0,40%

If all three portfolios have a cost income of 50%, the average risk cost can be multiplied by 5 before the bank makes a loss. Difficult to say which business model is superior.



The example shows that it is important to relate risk cost to the profitability of a portfolio (RoA) in order to determine the asset quality. The level of profitability is an important token of how much (credit) losses a bank can absorb before having to dip into its amount of Tier 1 capital.

ABOUT THE GROUPEMENT EUROPÈEN DE BANQUES (GEB E.E.I.G.)

The G.E.B. was founded in 1981 at the suggestion of the Bureau de Rapprochement des Entreprises of the European Commission in anticipation of the single European market.

The G.E.B. is a not for profit organisation and focuses on exchanging information on the financial and banking situation of the countries represented.

Observing different markets and studying trends helps the members adapt to an ever-changing financial environment, improve competitiveness and develop customer care. In brief, acquiring knowledge leads to improvements in existing and new services.

Twenty eight different banks from several European countries have been part of the G.E.B. in its more than 30 years' history and they have met more than 40 times.

During the annual General Management Meeting of 2012, held in London, GEB members resolved to establish a European Economic Interest Grouping (EEIG) according to the Council Regulations of European Economic Communities No. 2137/85, having its official address in Brussels. To this purpose a new agreement and statutes were drawn up and signed in June 2014.

The spirit of the Group is well described in the following excerpts from the "Lettre d'Intention" signed by member banks when joining the G.E.B.:

"With the aim of developing customer-assistance, observing various markets, seeking advice, examining different initiatives and trends, and acquiring more international know how, a number of banks established a group under the name of G.E.B. (Groupement Européen de Banques). The development of such a group allows the transfer of banking, commercial and EDP information, as well as the exchange of employees for training purposes or reciprocal arrangements for customers, in fact all activities considered of common interest."