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Capital Optimization

The impact of the new regulatory framework

Milan, 23 April 2015

Introduction

- Since the global financial crisis regulators have been trying to address perceived inadequacies in the financial industry regulatory framework
- The main outcomes of the new regulatory framework include higher capital requirements, increased demand of high-quality capital, a leverage ratio, an international liquidity framework, a regulatory framework for global systemically important banks (G-SIBs), ongoing work related to RWA reliability and comparability, new disclosure standards
- Regulators are using new tools to supervise banks' safety, among which asset quality reviews and stress test, that may become standard methodological approaches
- In a market environment where earnings from traditional banking activity are already under pressure due to the economic crisis, regulatory reforms have the potential to negatively affect banks' return on equity
- Effective capital management has become extremely important, not only to improve capital adequacy, but mainly as one of the few strategies available to restore profitability and enable growth
- RWA optimization is a component of capital management that allows to reduce regulatory capital consumption, i.e. the denominator of capital ratios.
- RWA optimization can be achieved through a range of actions that goes from minimizing RWA consumption of current assets, to portfolio optimization strategies and business model changes.

Agenda

1. **Regulatory interventions**
2. Capital Optimization
3. Impacts on capital optimization drivers
4. Conclusions

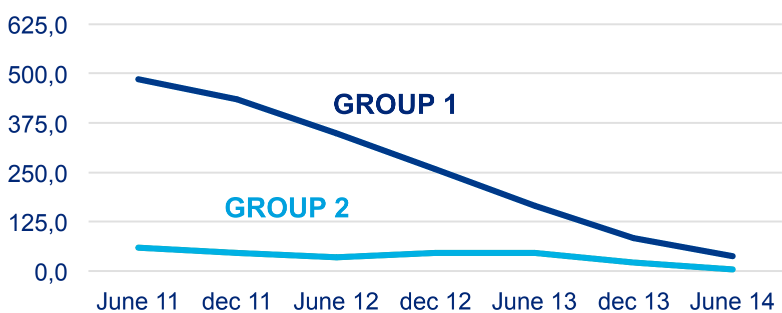
Regulatory interventions

From Basel 2.5 and Basel 3 to EMIR

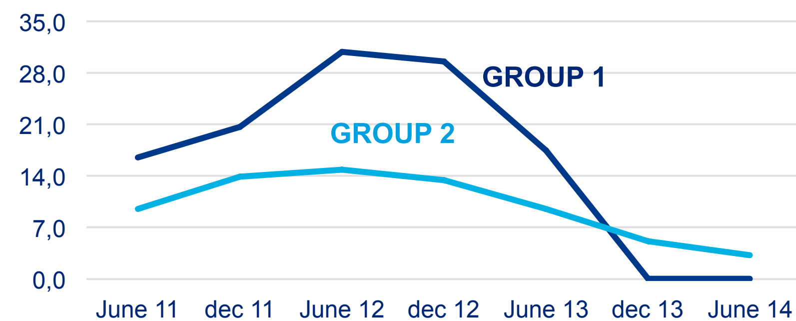
Basel 2.5 and Basel 3

1. ▪ Stressed VaR + IRC
2. ▪ Exposures to **Central Counterparties**
3. ▪ **Leverage** ratio Enhanced Risk coverage
4. ▪ Raising quality, consistency and transparency of capital
5. ▪ **Capital Conservation Buffer**
   ▪ **Countercyclical Buffer**
6. ▪ Liquidity Coverage Ratio (**LCR**)
   ▪ Net Stable Funding Ratio (**NSFR**)
   ▪ Management of intra-day liquidity
7. ▪ Regulatory framework for G-SIBs

Capital shortfall in € bn* (source EBA)



Leverage ratio shortfall in € bn (source EBA)



* Including Capital Conservation Buffer (2019).
As a result of the 2014 Comprehensive Assessment, **the total capital requirement impact is €262.7 billion** as of October, 2014

EMIR and Margin requirements for non-centrally cleared derivatives

1. ▪ **Mandatory Clearing** through CCPs for standardized derivatives
2. ▪ **Harmonized framework** for clearing services
3. ▪ **Strengthened risk management** requirements for non cleared derivatives
4. ▪ Reporting to **trade repositories** (TRs)

Regulatory interventions

Reducing excessive variability in banks’ regulatory capital ratios

- In November 2014, the Basel Committee on Banking Supervision issued the report “*Reducing excessive variability in banks’ regulatory capital ratios”* aimed at **addressing excessive variability in risk weighted asset calculation** with the objective of improving consistency and comparability in bank capital ratios
- The main steps the Committee is taking in order to reduce the level of observed variation in capital ratios across banks are listed below:

1. POLICY MEASURES

Objective: (i) Improving standardized approaches for **floors** calculations and **benchmarking** (ii) undertaking a more **fundamental review of modelling practices**

Measures: (i) Review of the Standardized Approach (ii) Capital Floor (iii) Banks’ credit risk modelling practices (iv) Banks’ market risk modelling practices (v) Leverage ratio

2. DISCLOSURE

Objective: Strengthening the **disclosure requirements** related to risk weights by amending Pillar III of the Basel framework

Measures: New Basel framework’s Pillar III disclosure requirements proposed in June 2014

3. ONGOING MONITORING

Objective: Ensuring proper implementation by monitoring outcomes of risk weighted asset variability through **Hypothetical Portfolio Exercises (HPEs) under Committee’s RCAP**

Measures: (i) Ongoing program of hypothetical portfolio exercises (ii) Analysis of the remaining material asset classes in the banking and trading book

Regulatory interventions

Focus: Policy measures for reducing excessive variability

Type of policy response		Status	Finalisation
Policy measures			
1) Review of the Standardised Approaches	Credit risk	Consultation published December 2014	End-2015
	Market risk	Third public consultation completed	End-2015
	Operational risk	Proposed revisions published October 2014	Mid-2015
	Counterparty credit risk	Document published March 2014	End - 2017
2) Capital floors	Replacement of the Basel II transitional floor with a permanent floor based on the SA for credit, market and operational risk	Consultation document published end-2014	End-2015
3) Credit risk internal models	Constraints on credit risk model parameter estimates (eg LGD parameter for low-default exposures; maturity of revolving facilities)	Consultation by mid-2015	End-2015
	Alignment of definitions of exposures under IRB and revised SA		
	Guidance to support the risk models framework (eg validation of risk models; “margins of conservatism” in model estimates)		
4) Market risk internal models	Greater standardisation of traded market risk model requirements (eg use of historical data; treatment of correlation)	Third public consultation completed	End-2015
5) Leverage ratio	Complementary measure aimed at restricting the build-up of excessive leverage and at mitigating model risk	Exposure definition finalised –monitoring and calibration 2015-17	Disclosure 2015 Implementati on 2018

Regulatory interventions

New Regulatory proposals

REGULATORY PROPOSALS

Supervisory Review and Evaluation Process (SREP)

- Additional capital requested by the supervisor is to be composed of 56% CET1
- Competent authorities should determine additional own funds requirements on a risk-by-risk basis, using supervisory judgment, ICAAP calculations, benchmark calculations and other relevant inputs

EBA Proposals on CVA Exemptions

- EBA Opinion on CVA (February 2015)

Treatment on Sovereign Exposures

- ESRB report on the regulatory treatment of **sovereign exposures**
- Italian institutions would face **additional capital requirements of €2.6 billion**

Interest Rate Risk of Banking Book

- A consultation paper is expected in 2015 that should change Pillar II treatment and possibly introduce a Pillar I requirement

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Capital optimization

Drivers

DATA QUALITY

- Data errors
- Data gaps

MODELS & APPROACHES

- Internal model approaches
- Improved coverage and granularity of risk models

REGULATORY INTERPRETA

- Interpretation of unclear or ambiguous rules

PROCESSES

- Risk mitigation processes
- Risk-adjusted pricing
- Capital allocation

PORTFOLIO OPTIMIZATION

- Deleveraging
- Risk transfer
- Reducing/eliminating RWA-consuming business lines

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Impacts on capital optimization

Assessing the effects of the new regulatory framework

	REGULATORY INTERVENTIONS IMPACTS
DATA QUALITY	**Data quality remains a key driver** in RWA optimization as data errors and gap will continue to have a strong negative impact on regulatory capital calculations.
MODELS & APPROACHES	Risk weights have too frequently declined without a genuine reduction in risk in the banking system, undermining the credibility of banks' internally-modelled risk weights. For this reason internal models will have **less space to be a capital optimization driver**
REGULATORY INTERPRETATION	There will be **less space for different interpretations of capital standards** as ensuring consistent implementation is a priority for regulators
PROCESSES	**Risk-adjusted pricing** and capital allocation is becoming a market practice Risk-mitigation processes, in particular collateral management, will play a key role, also due to new clearing and margining requirements
PORTFOLIO OPTIMIZATION	In a low yield environment, the analysis of **trade-off opportunities** between increasing Raroc and reducing RWA will be a key driver in banks’ business model decisions

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Key takeaway messages

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Capital shortage

- European banks are no longer confronting a severe capital shortage as in the aftermath of the financial crisis
- ECB Comprehensive assessment decreased the total stock of available capital
- The regulatory framework is not consolidated yet and **forthcoming reforms may lead to additional capital needs**

Profitability

- RWA optimization is not just an answer to new regulations since a capital efficient business model is also a way to **increase banks' profitability**

Capital-light business model

- **Processes and portfolio optimization will increase their relative importance** as RWA optimization drivers, data quality is likely to maintain its central role, whilst models and rules' interpretation will have a lower impact

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