Risks, regulation, supervision

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Risks

Overview of the main risks and vulnerabilities in the EU banking sector

		Bank risk	Risk drivers	Level of risk: Last quarter (memo) – Level	Level of risk: Last quarter (memo) – Expected Trend	Level of risk: Current quarter – Level	Level of risk: Current quarter – Forward Trend	Contributing factors/interactions
Capital	Pillar 1	Credit risk	Slow reduction of NPLs, structural and market impediments for NPL reduction, risk of rising impairments		→		→	Banks only slowly reduce their non-performing legacy assets. Among the main impediments to a faster reduction are slow judiciary and repossession processes as well as inefficient secondary markets. Also, low market prices for NPLs, which are often below their net book values, negatively affect the bank' efforts to reduce NPLs. Even though flows of new impairments are currently rather low in historical comparison, they might again increase, depending on future economic developments in emerging and developed markets.
Capital	Pillar 1	Market risk	Heightened market volatility, risk from declining market liquidity		→		→	Financial markets have remained volatile, increasingly driven by political events. Volatility is expected to persist. There is a persistent risk of a sudden decrease in market liquidity, which would additionally accelerate market volatility.
Capital	Pillar 1	Operational risk	Risks from IT outsourcing, fragmented and ageing IT systems, cyber attacks		→		→	As banking operations increase their dependence on IT platforms and telecommunication networks, concerns about connectivity and outsourcing to third party providers have increased. Operational risks are also negatively affected by fragmented and ageing IT systems. Cyber-attacks remain a threat.
Capital	Pillar 2	Concentration risk, IRRBB and other	Low interest rate environment		→		→	The current low interest rate environment remains a burden on banks' profitability. But also a potential increase in interest rates might in the short term pose additional threats to banks' profitability, with faster-rising refinancing costs than interest income. An environment of low interest rates contributes to banks' increased appetite for higher risk exposures.
Capital	Pillar 2	Reputational and legal	Existing and new cases of misconduct, lengthy processes till settlement		→		→	Compensation and redress payments remain high. Lengthy processes until cases of harmful practices are settled add to uncertainties among consumers and banks. New occurrences of misconduct regularly come up.
Capital	Pillar 2	Profitability	Low interest and fee income, stickiness of costs		↑		→	Declining interest and fee income negatively affect banks' operating income. Profitability is additionally negatively affected by the stickiness of banks' costs.

Source : EBA – Risk Dashboard Q3 - 2016

Risks

	Bank risk	Risk drivers	Level of risk: Last quarter (memo) Level	Level of risk: Last quarter (memo) Expected Trend	Level of risk: Current quarter Level	Level of risk: Current quarter Forward Trend	Contributing factors/interactions
Liquidity & Funding	Access to funding and maturity distribution	Reduced issuance volumes amid heightened market volatility	■	↑	■	→	Perceptions of heightened uncertainties have intensified and negatively affect banks' funding markets. In periods of heightened market stress, banks significantly reduced their issuance volumes of both unsecured and secured debt during recent months. However, most of the banks had already met their issuance needs for the year before so that they have not been under pressure to go to the markets at such time. Banks' maturity profile is unevenly distributed in the medium term.
Liquidity & Funding	Funding structure	Important role of central bank funding and deposits	■	→	■	→	Banks remain vulnerable in their funding mix to heightened market volatility. Most banks still have to issue MREL eligible instruments to meet own requirements, which might also negatively affect their funding costs. Central banks continue to play a major role in banks' overall funding mix. There is also a high weight of deposits in banks' funding mix. Even though deposits contribute to a stable funding mix, they might be volatile in severe stress scenarios.
Environment	Regulatory and legal environment	Risk weighted assets	■	→	■	→	Regulatory uncertainty includes, but is no restricted, to change in respect of risk weighted asset requirements, including potential minimum risk weights for sovereign exposures.
Environment	Fragmentation	Asset quality, profitability	■	→	■	→	Fragmentation of asset quality and profitability remains high among jurisdictions. The political risk might further negatively affect fragmentation.
Environment	Sovereign risk	Political risk, debt overhang	■	→	■	→	Increased political uncertainty adds to elevated risks from banks' sovereign exposures, driven by their increased volatility. Risks from a large debt overhang in some countries remain high.

Source : EBA – Risk Dashboard Q3 - 2016

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1. Risks

SYNTHÈSE DES PRINCIPAUX RISQUES POUR LE SYSTÈME FINANCIER FRANÇAIS : NIVEAU ET ÉVOLUTION

Principaux risques pour le système financier français	Niveau et perspective Décembre 2016
1. Risque macroéconomique *La croissance résiste en France et en zone euro dans un contexte caractérisé par : une croissance mondiale déprimée, un risque sur la croissance des économies émergentes (notamment Chine), des incertitudes de politique économique en hausse.*	↑
2. Risque lié à l'environnement de taux d'intérêt bas *Pression à la baisse sur la rentabilité des banques et des organismes d'assurance. Hausse de l'endettement des ménages et des entreprises. Accroissement du risque de taux en Europe via la transmission de la hausse des taux américains.*	→
3. Risque de marché *Volatilité des marchés accrue par les incertitudes politiques et accroissement du risque de taux lié à la pentification des courbes de taux et l'écartement des spreads, générant un risque de correction abrupte des prix des actifs obligataires.*	→
4. Risque immobilier *Vigilance accrue sur certains segments du marché immobilier commercial. Surveillance des critères d'octroi du crédit aux ménages du fait de la croissance de leur endettement.*	↑
5. Risque réglementaire pour les banques françaises *Pression réglementaire forte pour ajuster les modèles d'activité et les bilans des banques françaises afin de respecter les ratios bâlois et coût d'ajustement supplémentaire pour les banques encore incertain. Aléa pesant sur les négociations finales pour l'achèvement de Bâle 3.*	→

Risque systémique   Risque élevé   Risque modéré

Source : Banque de France – Assessment of Risks to the French Financial System – December 2016

Regulation

Enhanced requirements for capital and new requirements

Bâle III 2010

Better risk measurement

Enhance quality and quantity of capital

- More capital for market risks
- Enhance level of Core Capital
- More capital for systemic banks

Reduce leverage

- Simple measure not related to risks
- Limitation of debt

Liquidity

- Not part of Basel I and II even if liquidity is a major risk for banks

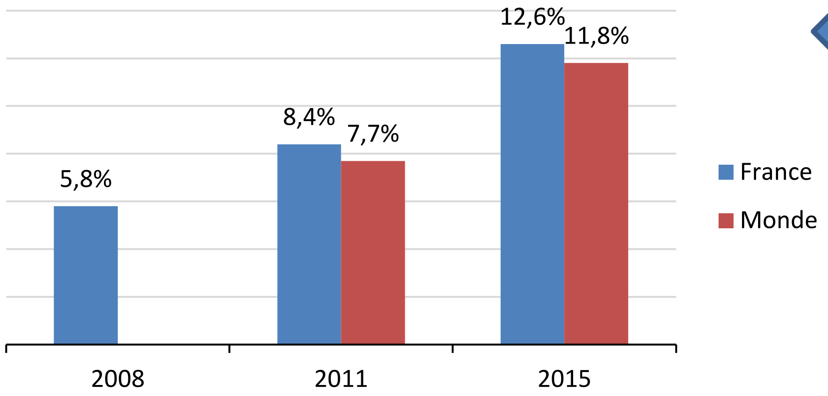
Limitation of pro cyclicality

- Capital add-ons for excessive credit growth

Interest rate risk taken into account in Pillar 2

Capital and liquidity level of French Banks already increased with Basel III

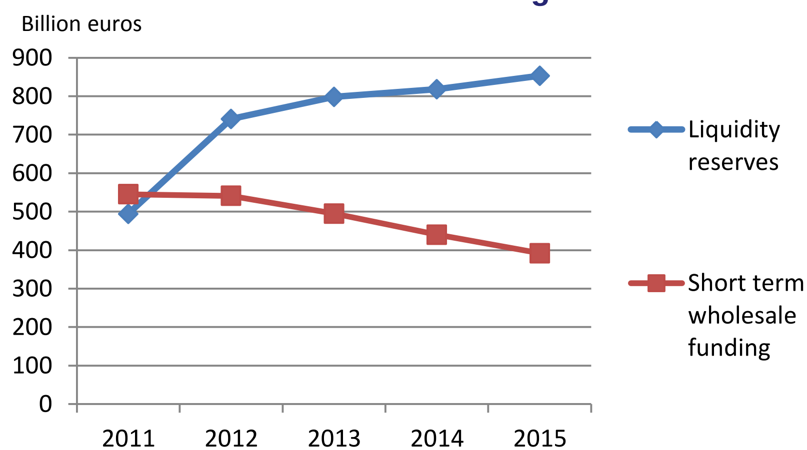
Increased capital ratio (CET1) since 2008



Source : SGACPR, BCBS (world = international banks with Tier 1 > 3 billion euros

Enhanced level and quality of capital with specific requirements for systemic banks

Increased liquidity reserves and reduced short term wholesale funding

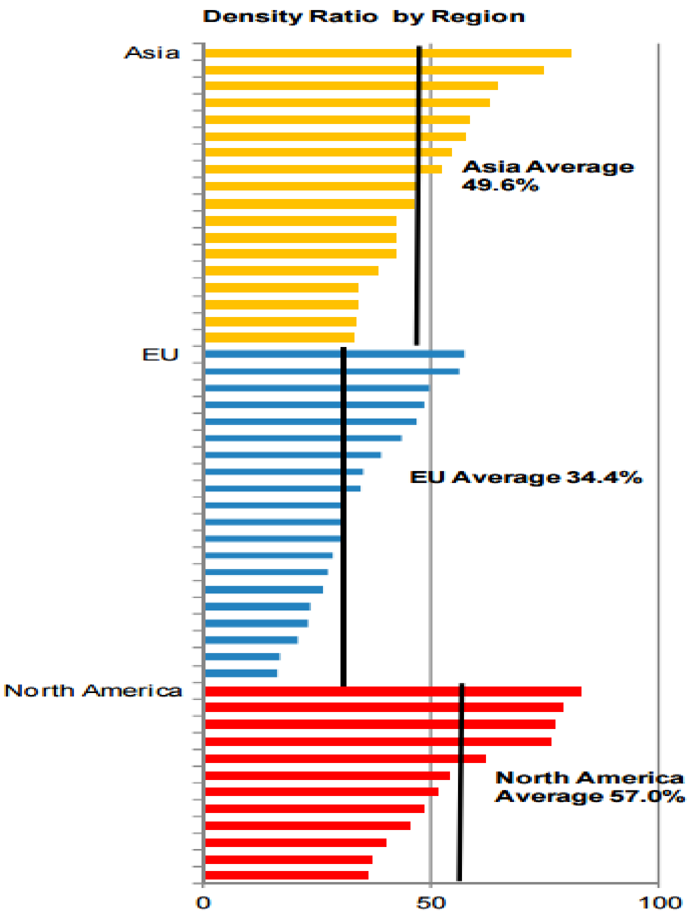


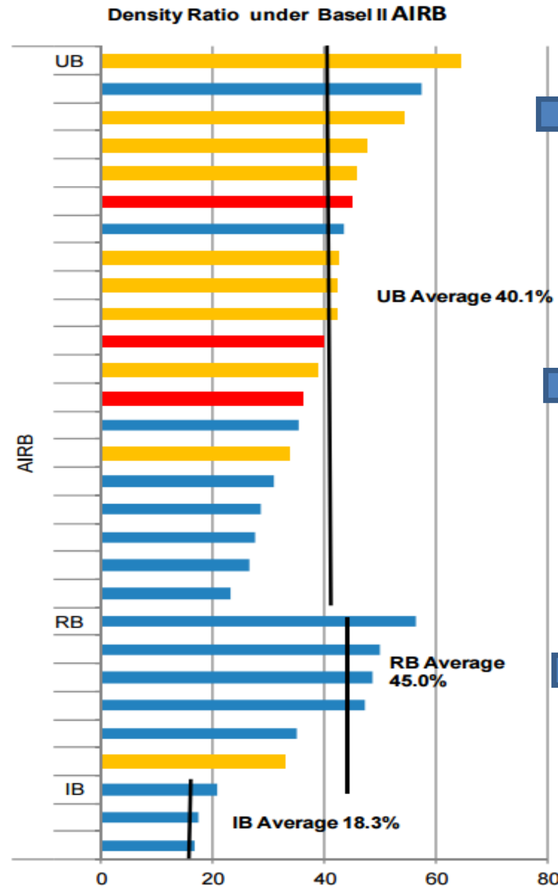
Source : communication financière

Rule for liquidity

An answer to the Risk Weighted Assets variability

Differences between banks





Source : ‘Working Paper’ du FMI (Fonds monétaire international) de mars 2012 : ***Revisiting Risk-Weighted Assets***

Different answers

BASEL COMMITTEE ON BANKING SUPERVISION
BANK FOR INTERNATIONAL SETTLEMENTS

Adapting Basel

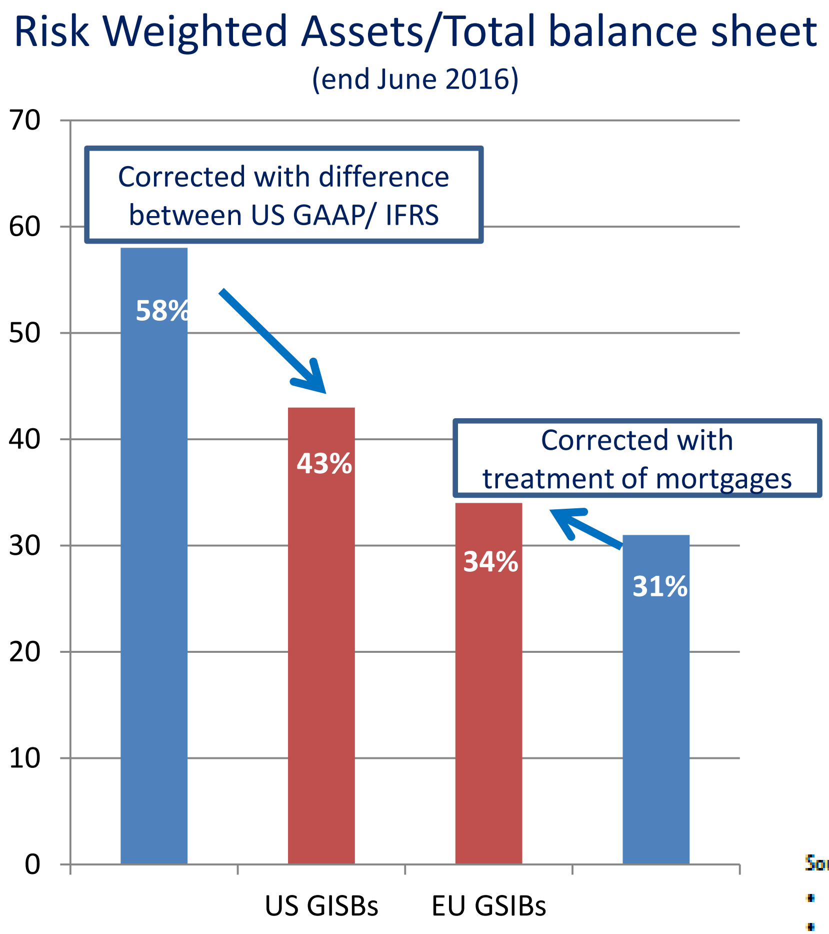
EBA EUROPEAN BANKING AUTHORITY

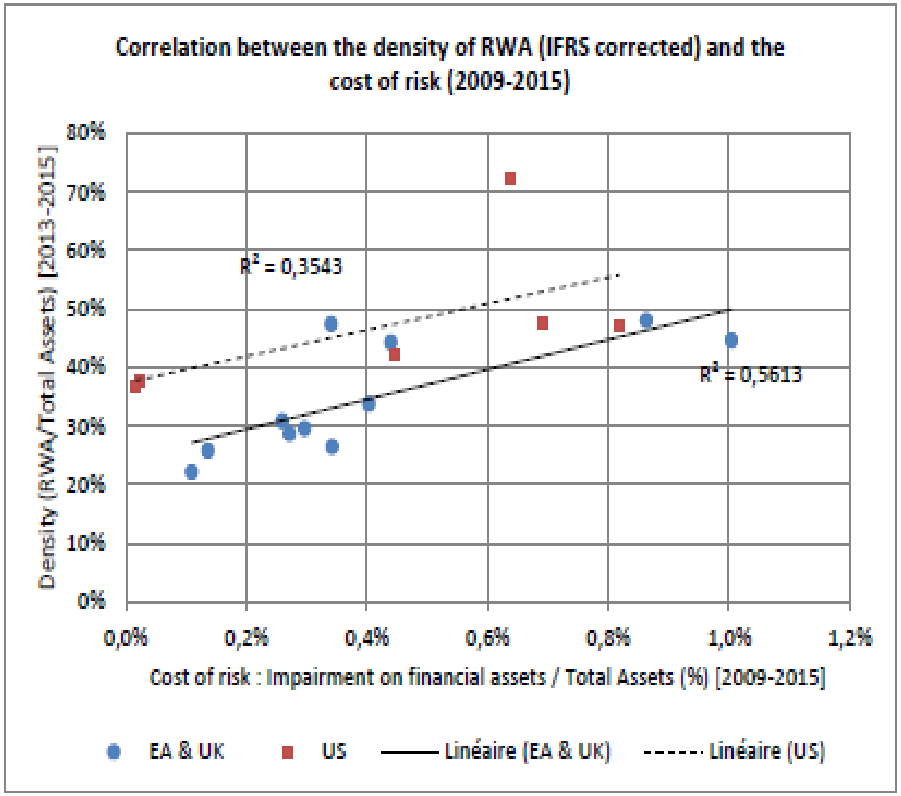
Harmonizing implementation rules

EUROPEAN CENTRAL BANK
BANKING SUPERVISION

Reviewing the implementation

Variability is explained also by objective differences



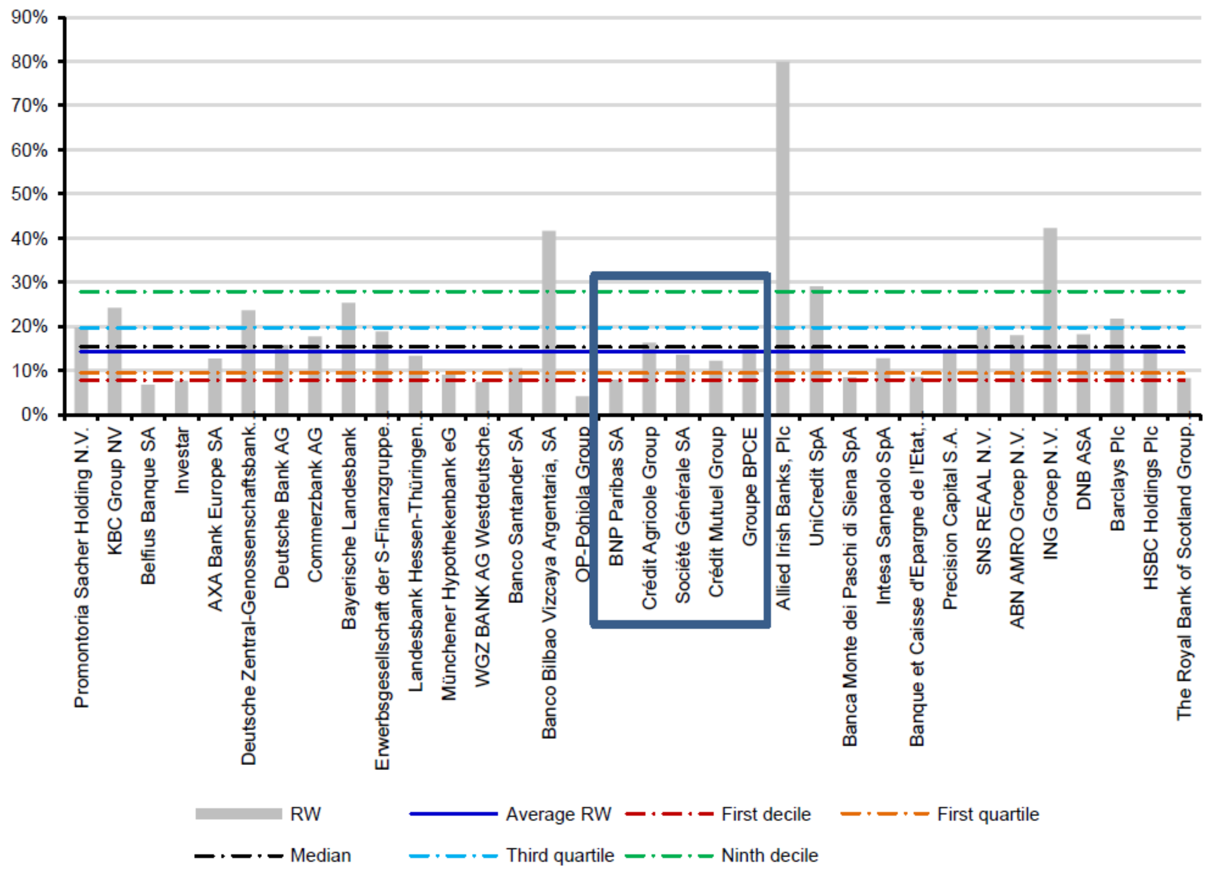


Sources: The raw data comes from:

- FDIC Global Capital Index for the Total Assets (TA) and the Total RWA.
- SNL for the Cost of Risk (Impairment on Financial Assets over Total Assets) for the year 2009-2013

Example for mortgages risk weighted assets

RWs of housing loans in France (A-IRB approach) at 30 June 2015



Source: EBA, Transparency Exercise; ACPR calculations

An average RWA of **14.2%** for French banks

But this is a **partial view** due the fact that credits are covered by substantial guarantees and in many cases, the banks are shareholders of the entities providing these guarantees and must deduct their stakes in them when determining their capital requirements.

Factoring in this additional cost materially changes the average RW which went up by more than 5 pp as at 30 June 2015 to **19,2%**.

Finalizing Basel 3 to give regulatory clarity

Main question: which **role for internal model** in the regulation?

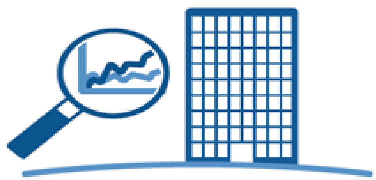
Objective for finalizing Basel 3: restore confidence in risk measurement by banks

In practice, finalizing Basel 3:

- **Credit risk measurement:** revised standardized approach and limitation to the use of internal model
- **Operational risk measurement:** review all the framework (new standardized approach and end of advanced method)
- Introduce an overall floor (***capital output floor)*** between the internal model and the standardized approach
- Introduce a specific **leverage requirement for systemic banks (G-SIBs)**, in addition to the 3 % Tier 1.

Supervision

SSM supervisory priorities 2017



Supervisory action:

- Thematic review of banks' business models and profitability drivers

In-depth examinations of Business models and profitability drivers

- in view of protracted ultra-low/negative interest rates
- with the possible repercussions of the UK's referendum on EU
- Membership
- potential risks emanating from the emergence of "FinTech" and non-bank competition

Supervisory action:

- Guidance and supervisory dialogue on NPLs
- Thematic review IFRS 9

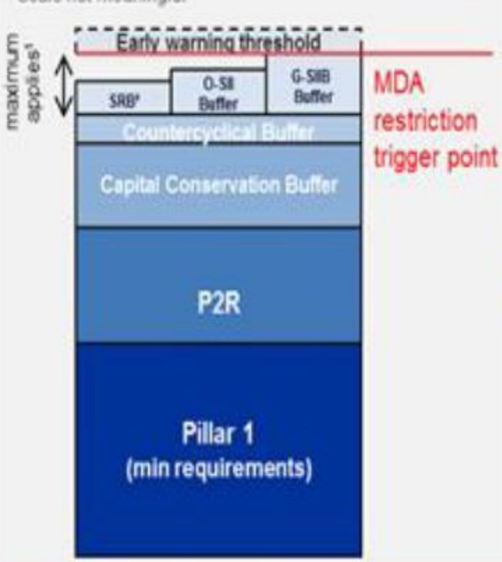
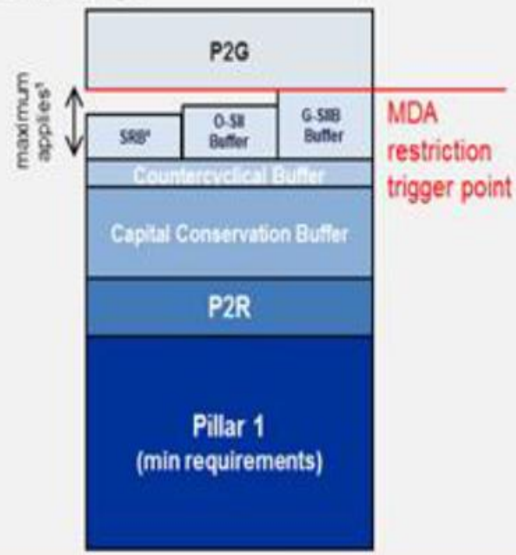
- Follow-up actions and supervisory dialogues with respect to the NPL Guidance
- Intensified review of the potential impact of IFRS 9 on banks and their degree of preparation
- To investigate excessive concentrations of credit risk in certain asset classes, such as shipping loans, European banking supervision intends to use a new approach combining both on-site and off-site elements

Supervisory action:

- Thematic review of compliance with BCBS 239
- TRIM
- Thematic review of banks' outsourced activities

- Finalize the ongoing thematic review of banks' compliance with the Basel Committee's principles for effective risk data aggregation and risk reporting (BCBS 239)
- Roll out of the multi-year targeted review of internal models (TRIM) with on-site inspections
- Promoting the continuous improvement of banks' ICAAPs and ILAAPs
- Thematic review to take stock of banks' outsourced activities and scrutinize how they are managing the associated risks (including IT risks)

Modified approach to Pillar 2 capital requirement

	SREP 2015	SREP 2016
Pillar 2	• Pillar 2 (MDA relevant)	• Pillar 2 Requirements (P2R) (MDA relevant) • Pillar 2 Guidance (P2G) (not MDA relevant)
Capital Conservation Buffer (CCB)	• Overlap with Pillar 2 (Gross Pillar 2)	• No overlap with Pillar 2
CET1 Stacking order	* Scale not meaningful 	* Scale not meaningful 
Capital composition	• Pillar 2: 100% CET1	• P2R & P2G: 100% CET1
SREP decision	• CET1 ratio	• P2R: CET1 ratio and Total SREP Capital Requirements (TSCR)[3] • P2G: CET1 ratio add-on

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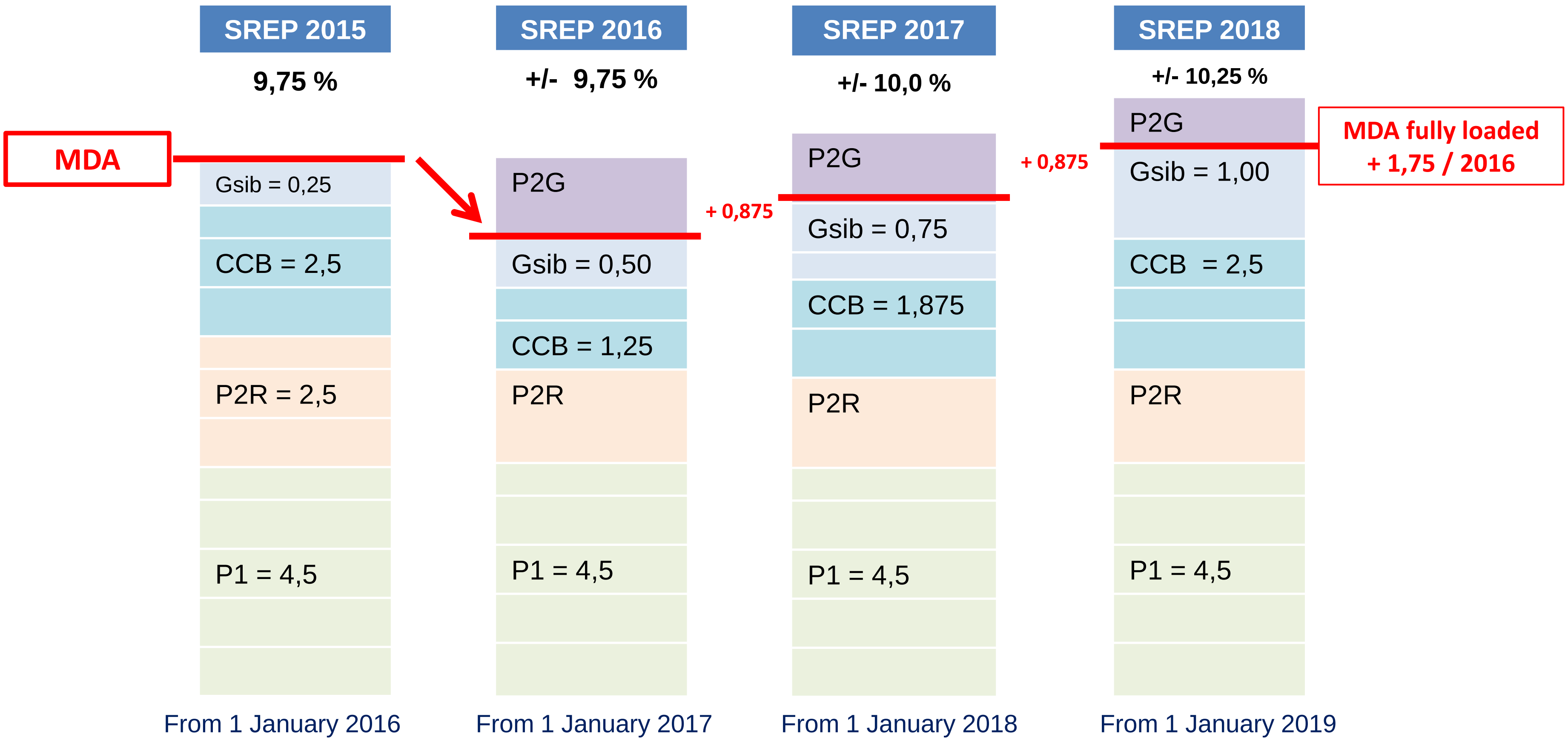
3. Supervision

What does it mean in practice ?

Example for a Gsib with 9,5 % requirement for 2016 and a 1 % systemic buffer



CCB not front loaded
Decrease P2R / 2015
New P2G not MDA relevant

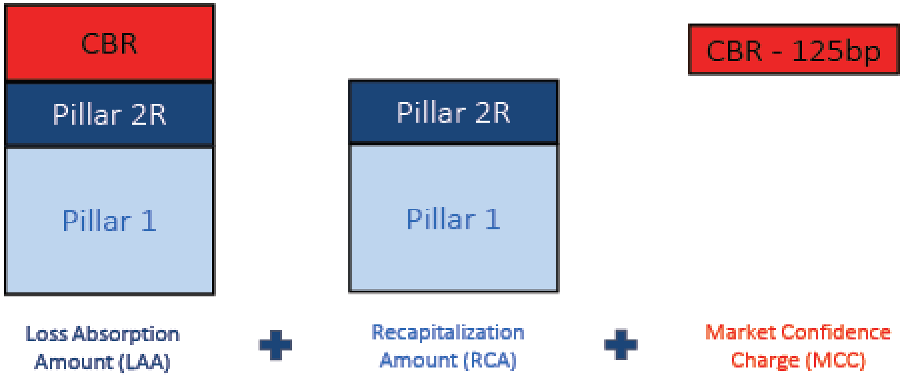
Some compensation between CCB and P2G

Supervision

The Single Resolution Board (SRB) is considering informative MREL targets

- "Industry dialogue of 28th November 2016 " on the new indicative MREL target based on the MREL delegated act (EBA RTS) and taking into account the new SREP methodology for 2016 (but not the revised regulation)

  - Informative MREL Targets in 2016 = Mechanical sum of three amounts



- Possible changes to take into account the proposed EU changing rules
  - distinction between MREL Requirement and MREL Guidance
  - possible adjustments to be made by the resolution authority, with the supervisory authority, to take into account the business model end the risk profile