

SP Global : Why Another Capital Ratio?

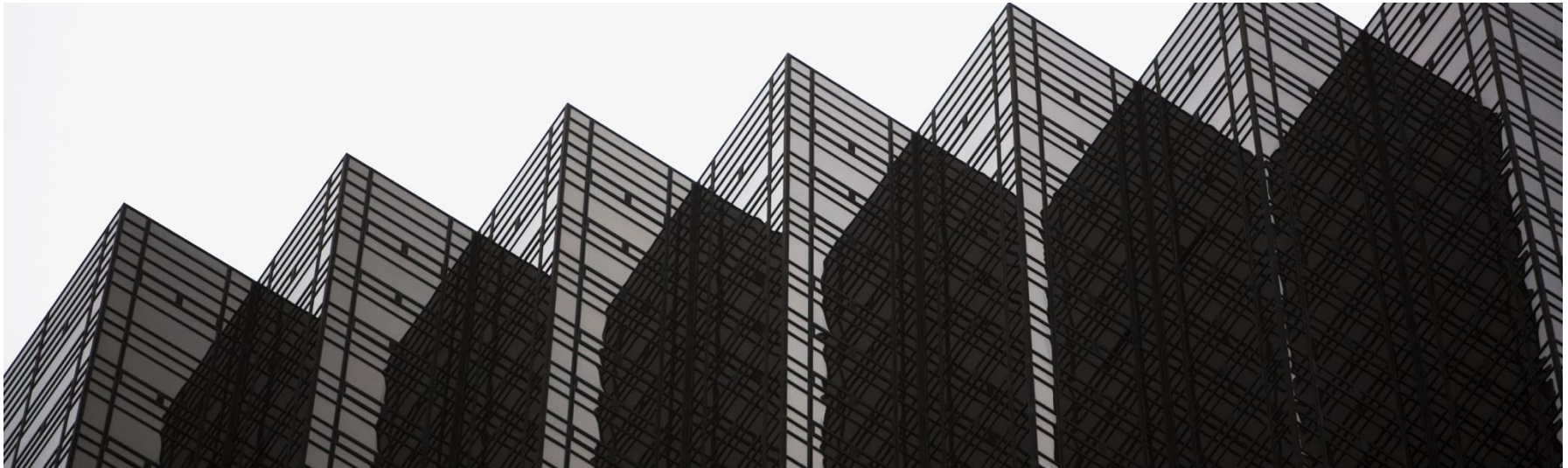
Date: 15 December 2016

Nicolas Malaterre
Senior Director

Mathieu Plait
Associate

EMEA Financial Services Ratings

Copyright © 2016 by S&P Global.
All rights reserved.



Agenda

- **Why Another Capital Ratio?**
- **Risk-Adjusted Capital Framework (RACF) Overview**
- **Bank Ratings Framework– Where Does RACF Fit In?**
- **Outlook For European Banks**
- **Appendix 1: BICRA and S&P RWs curves**
- **Appendix 2: Regulatory RWs vs S&P RWs – Illustrative Example**

Why Another Capital Ratio?

Why Yet Another Capital Ratio?

- **We first introduced our Risk-Adjusted Capital Framework (RACF) in April 2009 to address comparability issues with the regulatory ratios. We believe these issues will persist under Basel III and “Basel IV”.**
- **Regulatory Tier 1, Core Tier 1, CET 1 ratio.**
 - Key regulatory metrics, risk sensitive
 - Very complex under Basel II, Basel II.5 and Basel III
 - Comparability is blurred, within and across banking systems
 - National discretions (affect both the numerator and the denominator)
 - Methodological differences
 - Difference in banks’ internal models/estimates
 - While we think that internal model approaches are relevant and better capture the underlying risks in some instances we have concerns about the absence of global standardized validation framework among the national supervisors.
 - Timing differences in the regulatory framework implementation
 - Transition to Basel III will last up to 2023

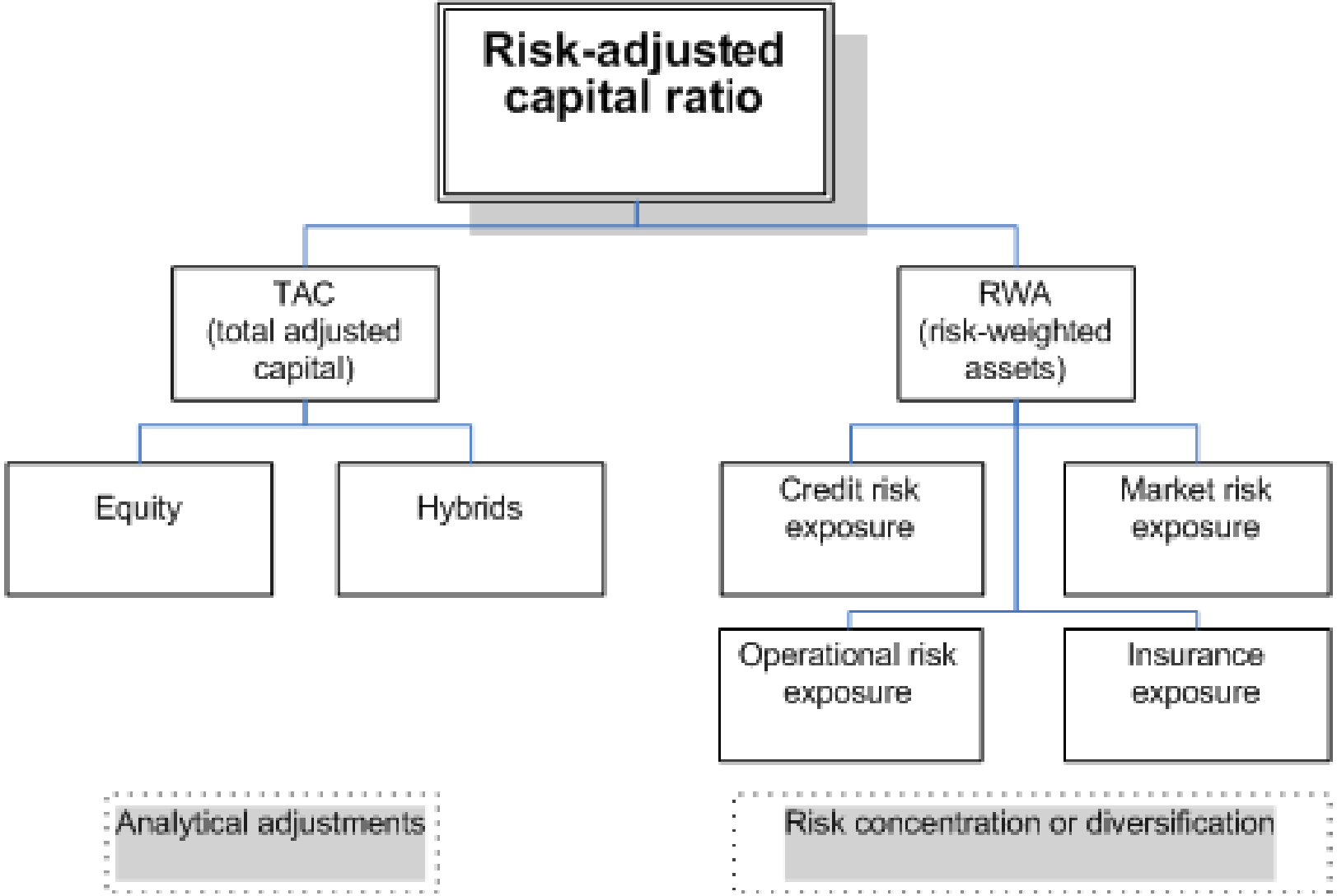
Why Yet Another Capital Ratio?

[Appendix](#) 

- **S&P also has different views on some risks and calibrations.**
 - S&P Credit Risk RWs are calibrated to a 'A' stress scenario
 - In such scenario, the GDP could decline by as much as 6 % over 3 years, unemployment could reach up to 15% and the home price could decline by 30%. The stock market could drop up to 60 % (for a developed economy)
 - S&P Market RWAs are calculated over 1 year horizon with a 99.9% confidence level
- **As we rate banks all over the globe it is critical for us to have to use capital ratios that are comparable. We also calculate RAC ratios for entities falling out of scope of the Basel Framework**
- **Therefore, while we monitor regulatory ratios, our capital assessment for banks is centred on RACF.**

Risk-Adjusted Capital Framework (RACF) Overview

Building Blocks For S&P's Risk-Adjusted Capital



S&P Risk Weights Risk-Weighted Assets

- RWs for each credit exposure class reflect Standard & Poor's own qualitative risk assessment of what could be unexpected losses under a 'substantial' stress scenario
 - Losses are calibrated to a 'A' stress scenario
 - In such scenario, the GDP could decline by as much as 6 % over 3 years, unemployment could reach up to 15% and the home price could decline by 30%. The stock market could drop up to 60 % (for a developed economy)
- We derived from these stress losses a risk weight equivalent that we apply to banks' exposure at default
 - Ex: Retail mortgages in a low risk country could generate in our opinion 150 bps of **unexpected losses**
 - $150\text{bp} / 8\% = 150\text{bp} \times 12.5 = 19\%$ is our benchmark **risk weight** for retail mortgage portfolios in very low risk countries
- Risk Weighted Assets for Market risk are calculated over 1 year horizon with a 99.9% confidence level
- A RAC ratio of 8% indicates that a bank has just enough capital to absorb this 'substantial' (i.e. 'A' level) stress scenario

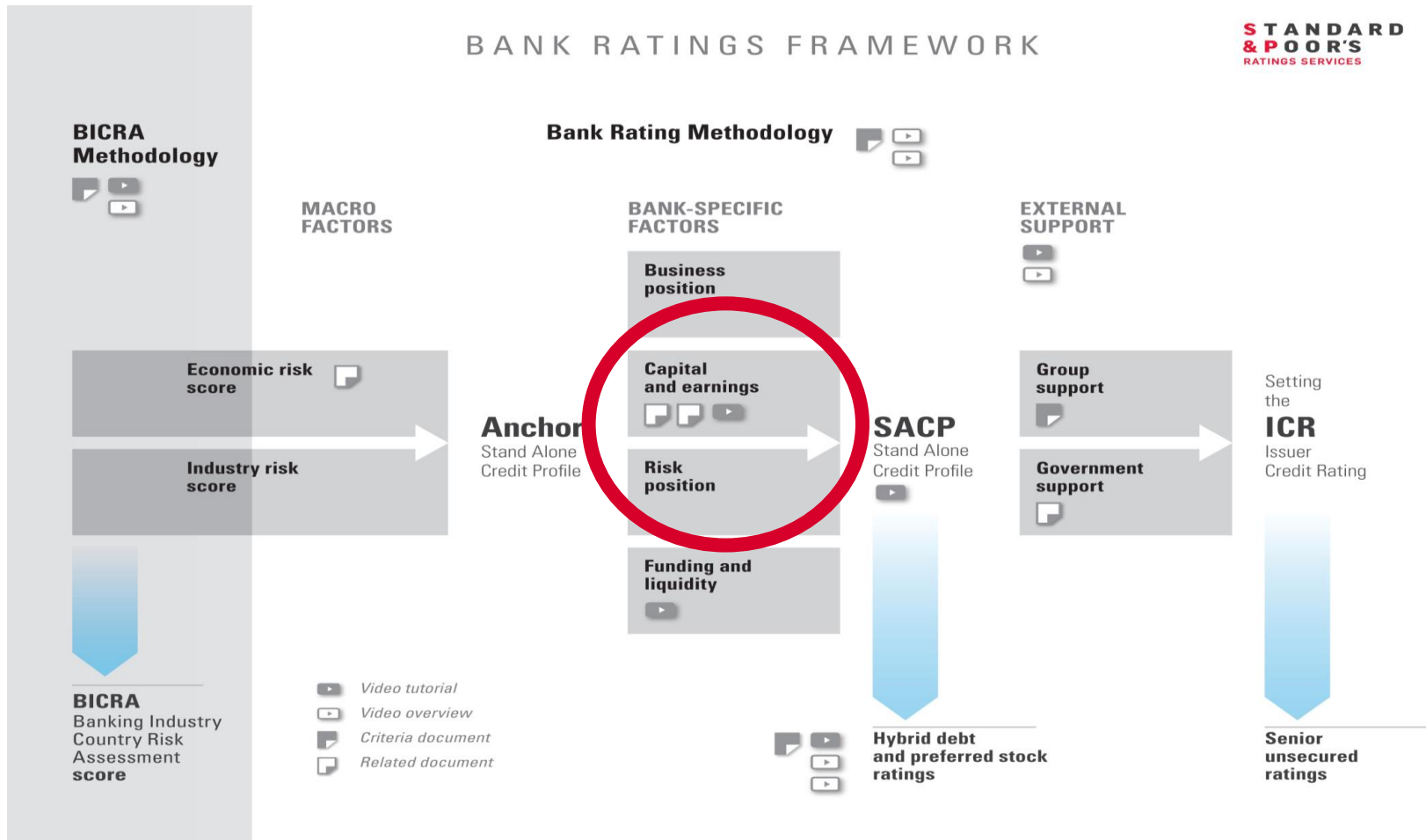
Risk Weights Differentiation: S&P's Approach

- The risk charges for corporate and retail exposure classes are differentiated based on the economic risk score.
- The risk charges for financial institutions are differentiated based on BICRA groups. BICRA is our methodology for assessing the risks relevant to national banking systems.
- The risk charges for sovereign exposures are differentiated based on Standard & Poor's sovereign ratings
- The risk charges for securitization exposures are differentiated based on assessments from rating agencies
- Risk charges are applied to Exposure At Default (EAD)
 - Adjustments to EAD for Credit Cards (10% of undrawn amounts taken as Credit Exposure) and Equity in the banking book
 - Where EAD is not available (e.g. in the U.S and some emerging countries.), S&P uses Basel Credit Conversion Factors assumptions



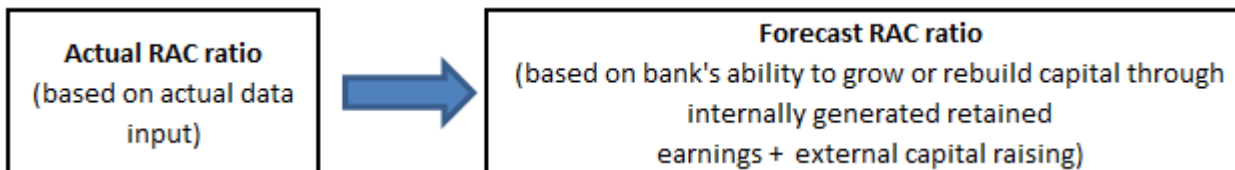
Bank Ratings Framework— Where Does RACF Fit In?

BANK RATINGS FRAMEWORK



- The projected RAC ratio is the key driver of **“Capital and earnings”**
- **‘Risk position’** serves to refine the view of a bank's actual and specific risks, beyond the conclusion arising from the standard assumptions in the capital and earnings analysis (i.e. RAC ratio)
- A comparative assessment, in relation to peers operating in banking systems with similar economic risk. We also look whether material risks are not adequately captured by RACF

From The Actual RAC Ratio To The SACP Impact



**Table 9
Capital Assessment**

Qualifier	Projected RAC ratio before concentration or diversification adjustments (%)
Very strong	More than 15%
Strong	More than 10% and up to 15%
Adequate	More than 7% and up to 10%
Moderate	More than 5% and up to 7%
Weak	3% up to 5%
Very weak	Less than 3%

**Capital and Earning
Score**
(all else being equal)

**Table 3
Using Bank-Specific Analysis To Determine The SACP**

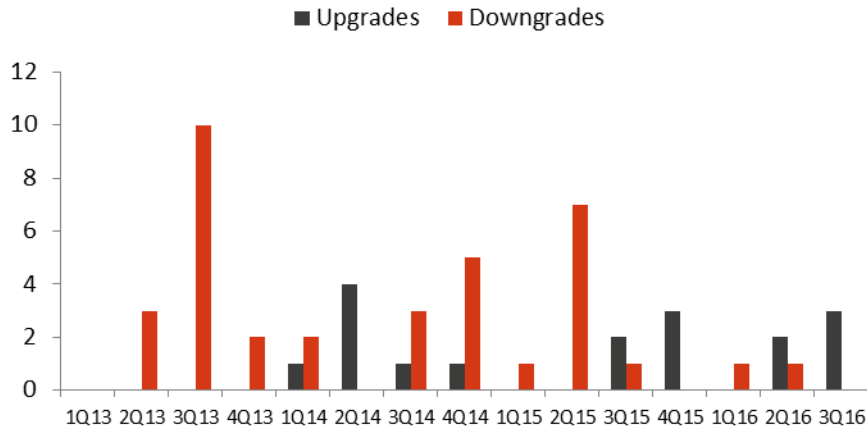
Capital and earnings* Anchor	'bbb-' or better	'bb+' to 'bb-'	Below 'bb-'
Very strong	+2 notches	+2 notches	+2 notches
Strong	+1 notch	+1 notch	+2 notches
Adequate	0 notches	0 notches	+1 notch
Moderate	-1 notch	0 notches	0 notches
Weak	-2 to -3 notches	-1 notch	0 notches
Very weak	-5 notches	-2 notches	-1 to -2 notches



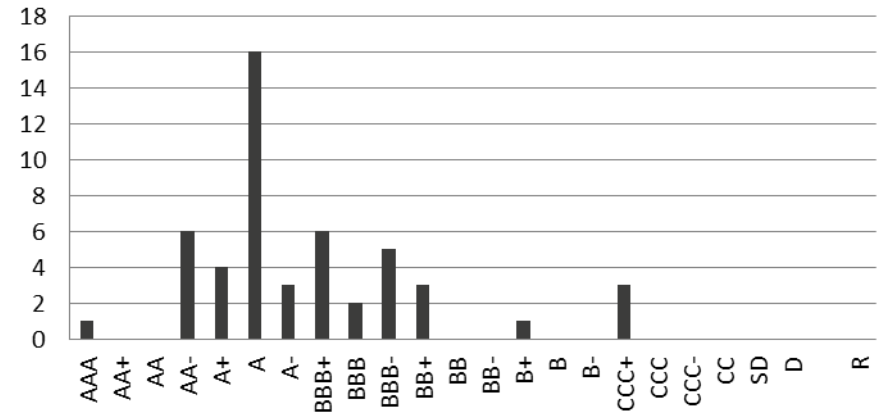
Outlook For European Banks

Top 50 Rated European Banks - Rating Trends

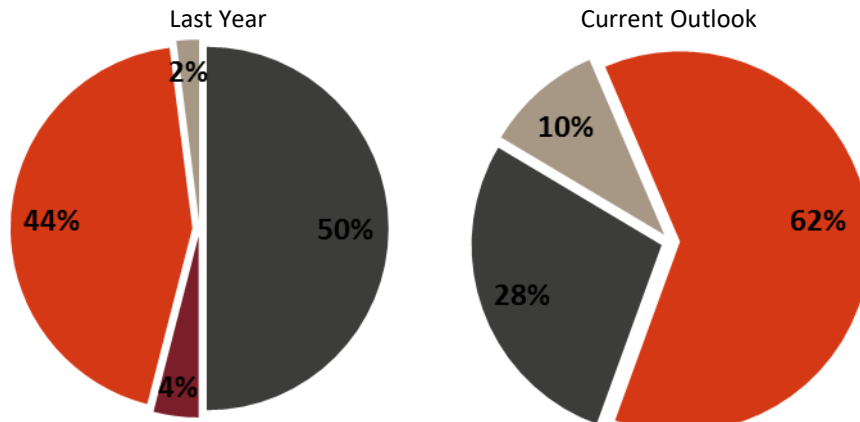
Historic Downgrades & Upgrades



Rating Distribution (ICR)



OL/CW Distribution



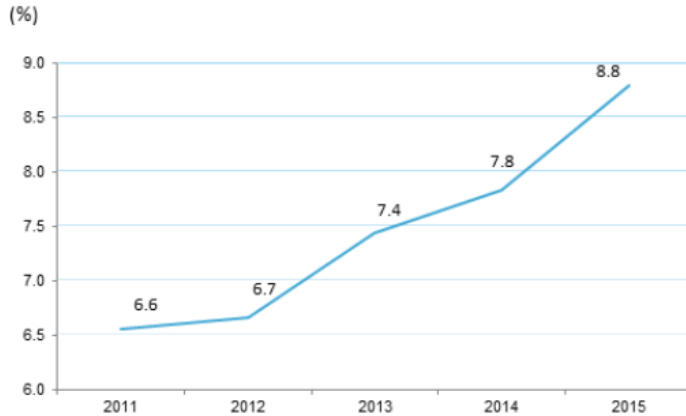
Source: S&P Global Ratings. All data as at: October 21, 2016. ■ Negative ■ CW Negative ■ Stable ■ CW Positive ■ Positive

Takeaways:

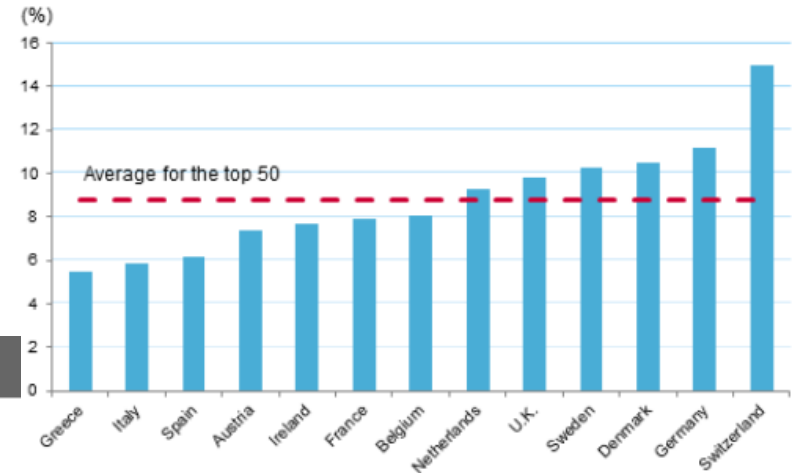
1. Concentration at "A"
2. Since mid-2015, 8 upgrades vs. 2 downgrades
3. Shift from Neg to Stable outlooks, linked to removal of government support
4. But Europe is far from being an homogenous zone.

More Resilient Balance Sheets Support These Trends

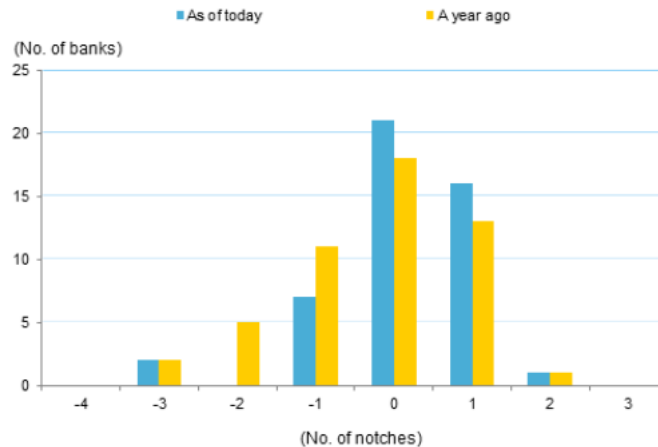
Average RAC Ratio For The Top 50 Rated Western European Banks, 2011-2015



Average RAC Ratio For The Top 50 Rated Western European Banks, 2015, By Country



Combined Notching Impact Of Capital & Earnings And Risk Position For The Top 50 Rated Western European Banks



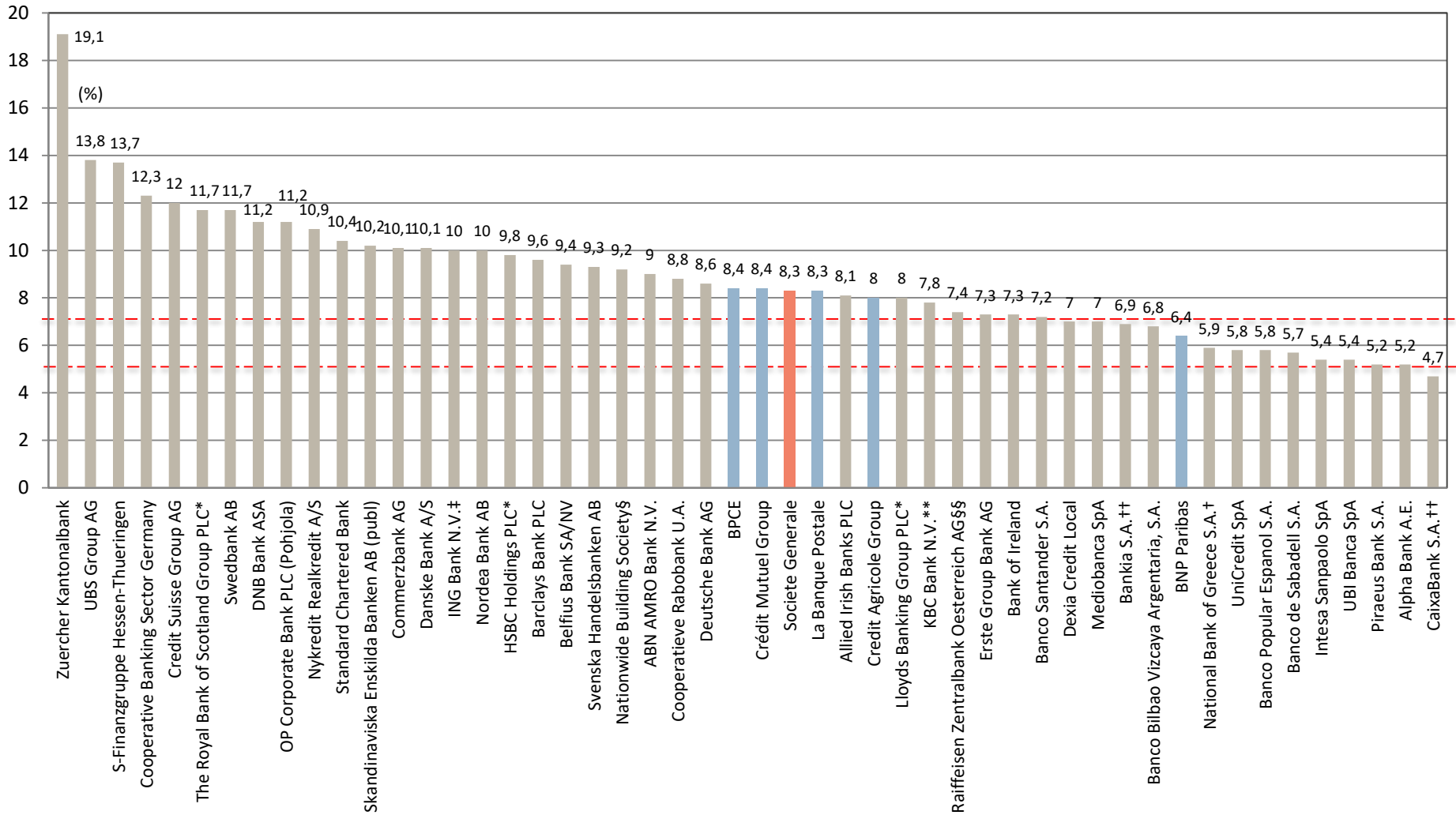
RAC--Risk-adjusted capital. Source: S&P Global Ratings.

Copyright © 2016 by Standard & Poor's Financial Services LLC. All rights reserved.

Source: S&P Global Ratings.

Copyright © 2016 by Standard & Poor's Financial Services LLC. All rights reserved.

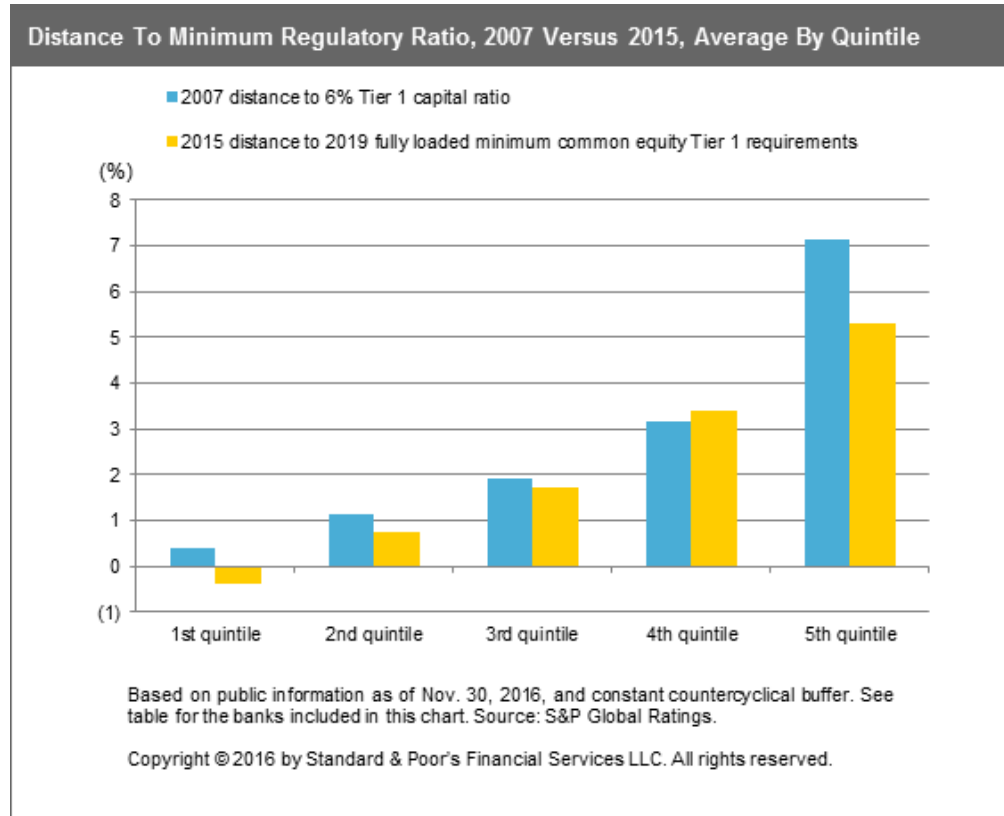
RAC Ratio / European Top 50 (Most Recent Historic Figures)



Note: The ranking is based on Tier 1 capital as published in The Banker in June 2016. All RAC ratios are calculated at the group level. *Holding company; the rating reflects that of the main operating company. § Nationwide Building Society (April 2015). †National Bank of Greece: Best estimate, †ING: The RAC ratio calculated at the operating bank level does not take into account part of the cash buffer managed at the holding company level (ING Groep) that we include in our forecast. **We calculate the RAC at the Group level. § § Referring to consolidated sector data ††RAC ratios are calculated at parent company level with group's consolidated financial statements.

Most Banks Don't Need More Capital, But The Flexibility To Use It In Times Of Stress

- Banks' limited capacity to use their enhanced capital bases without breaching much stricter minimum regulatory requirements undermines the benefits of having a stronger capital base.
- As a result, we believe that banks' pro cyclical behaviors and exposure to confidence shocks might not have improved as significantly as could have been expected.



Thank you

Nicolas Malaterre

Senior Director

Financial Services Ratings

T: +33 144 20 7324

Nicolas.malaterre@spglobal.com

Mathieu Plait

Associate

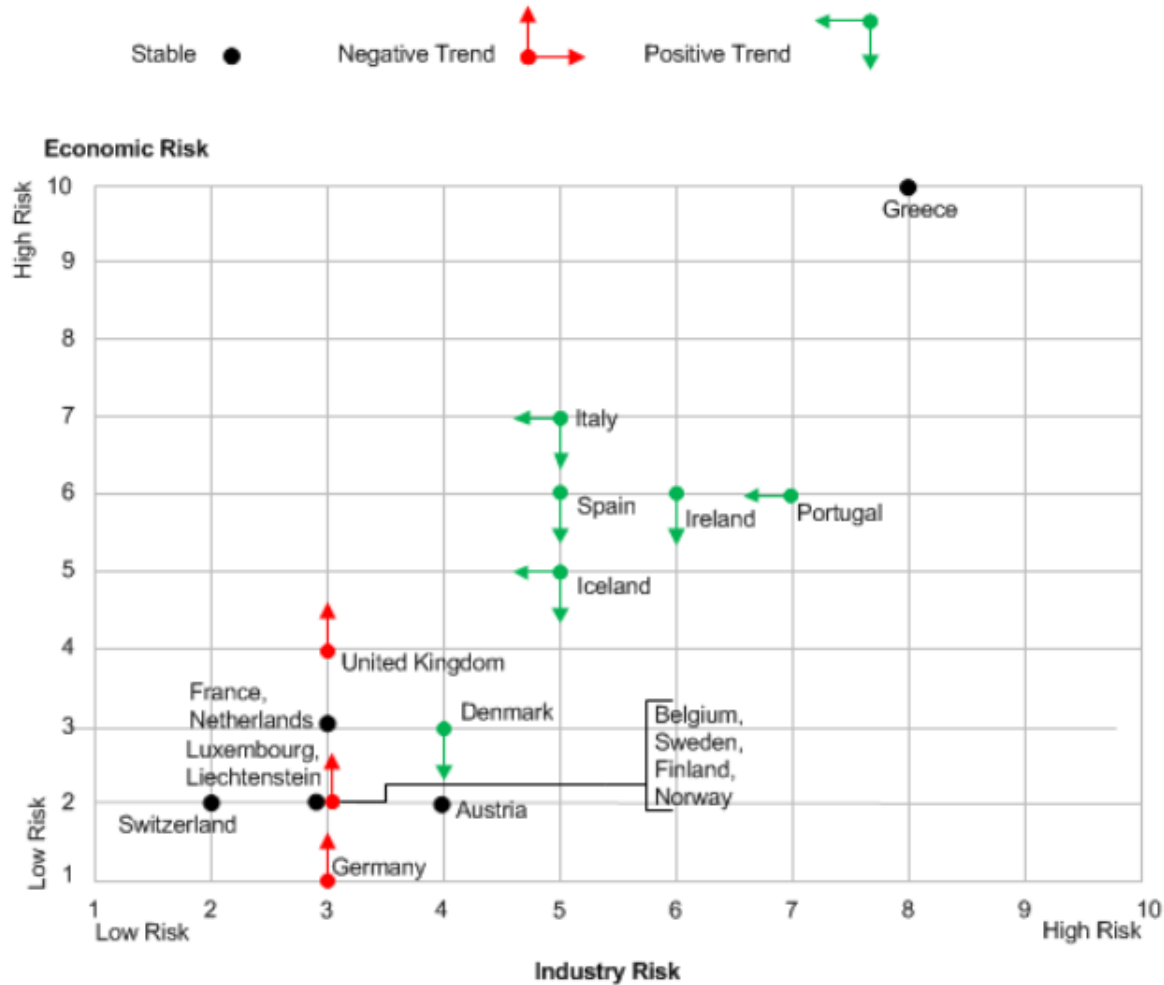
Financial Services Ratings

T: +33 144 20 7364

Mathieu.plait@spglobal.com

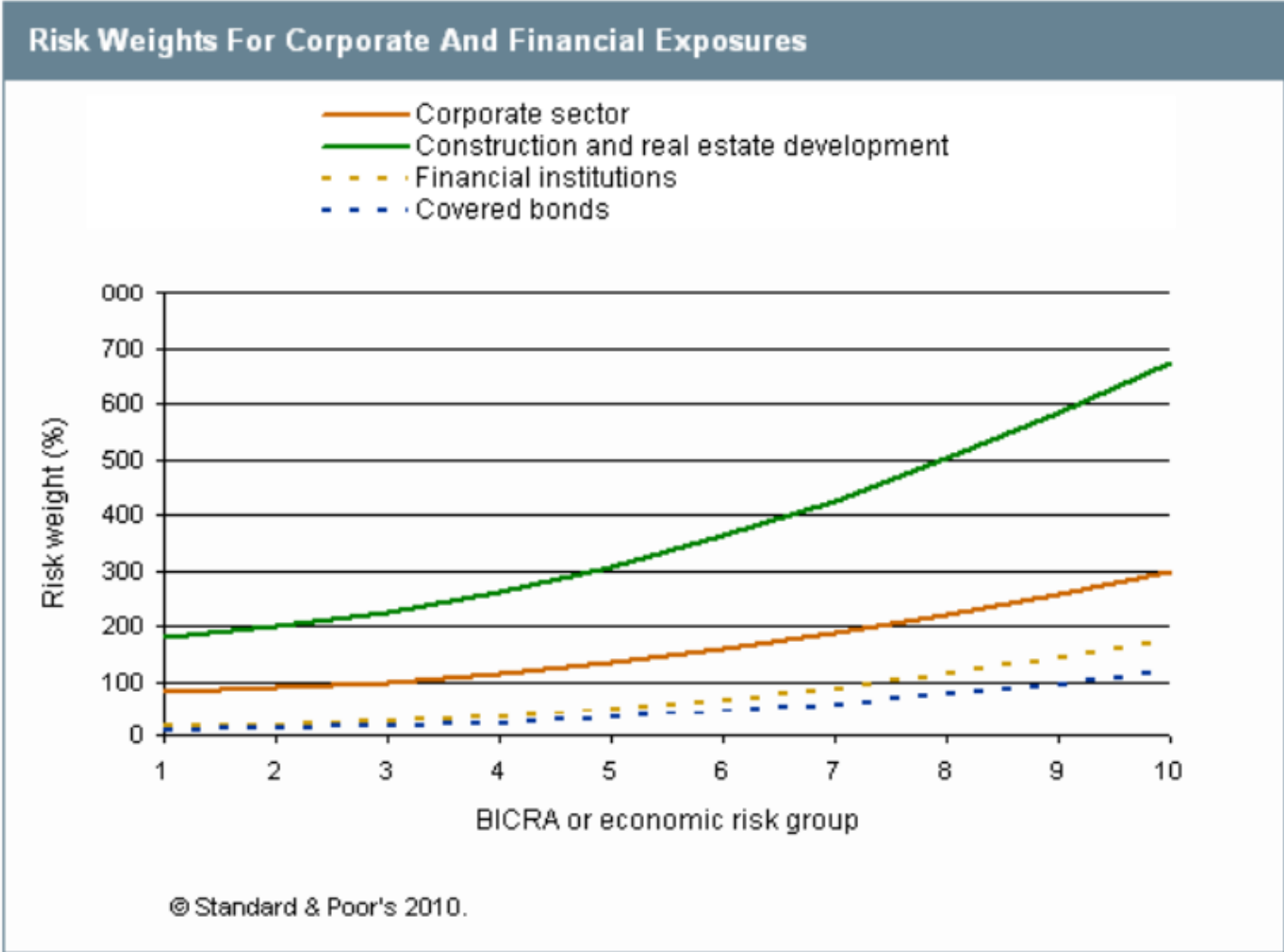
Appendix 1: BICRA and S&P RWs curves

BICRA Is Our Methodology For Assessing The Risks Relevant To National Banking Systems

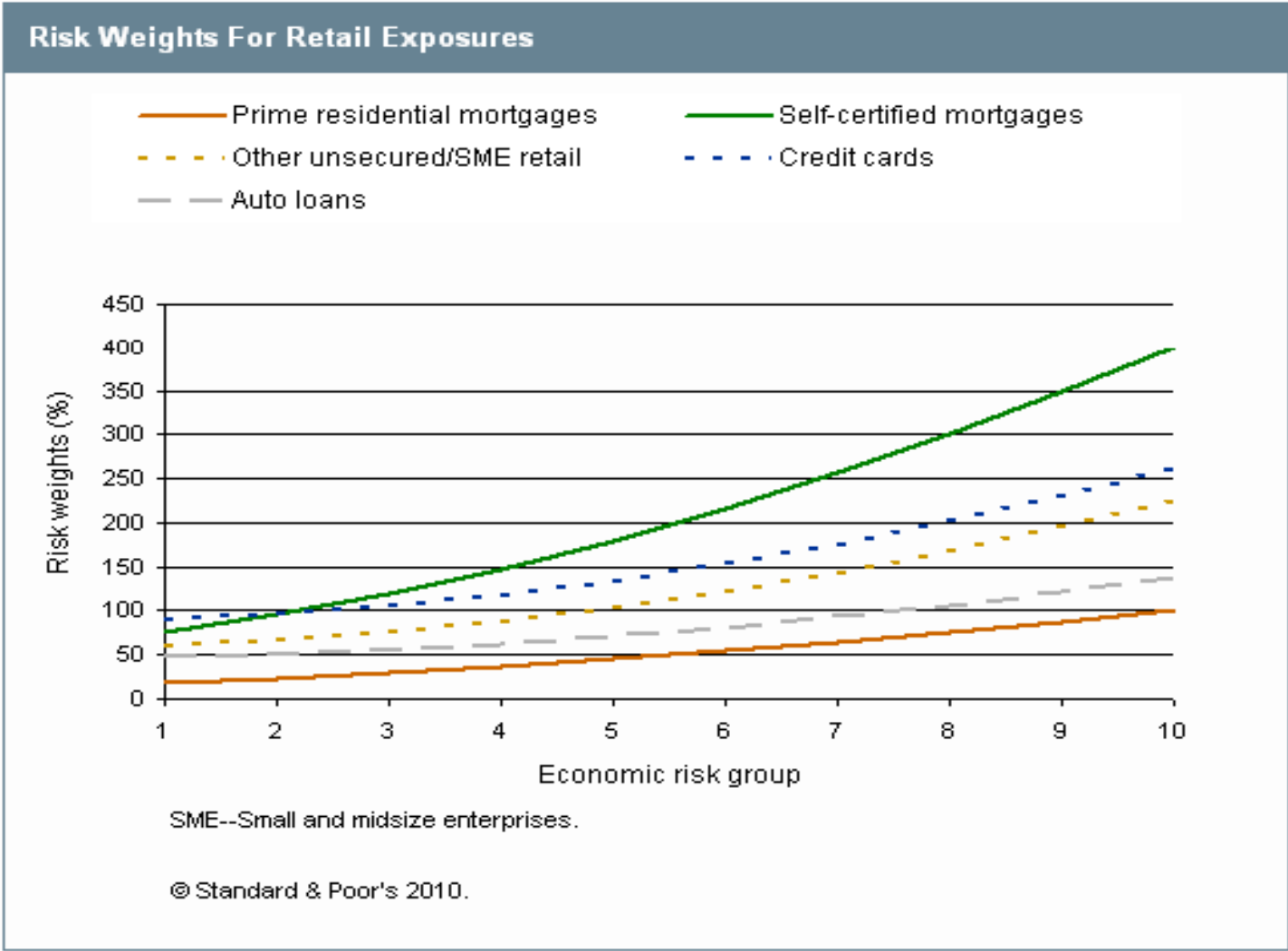


Source: S&P Global Ratings. Data as of Nov. 4th, 2016

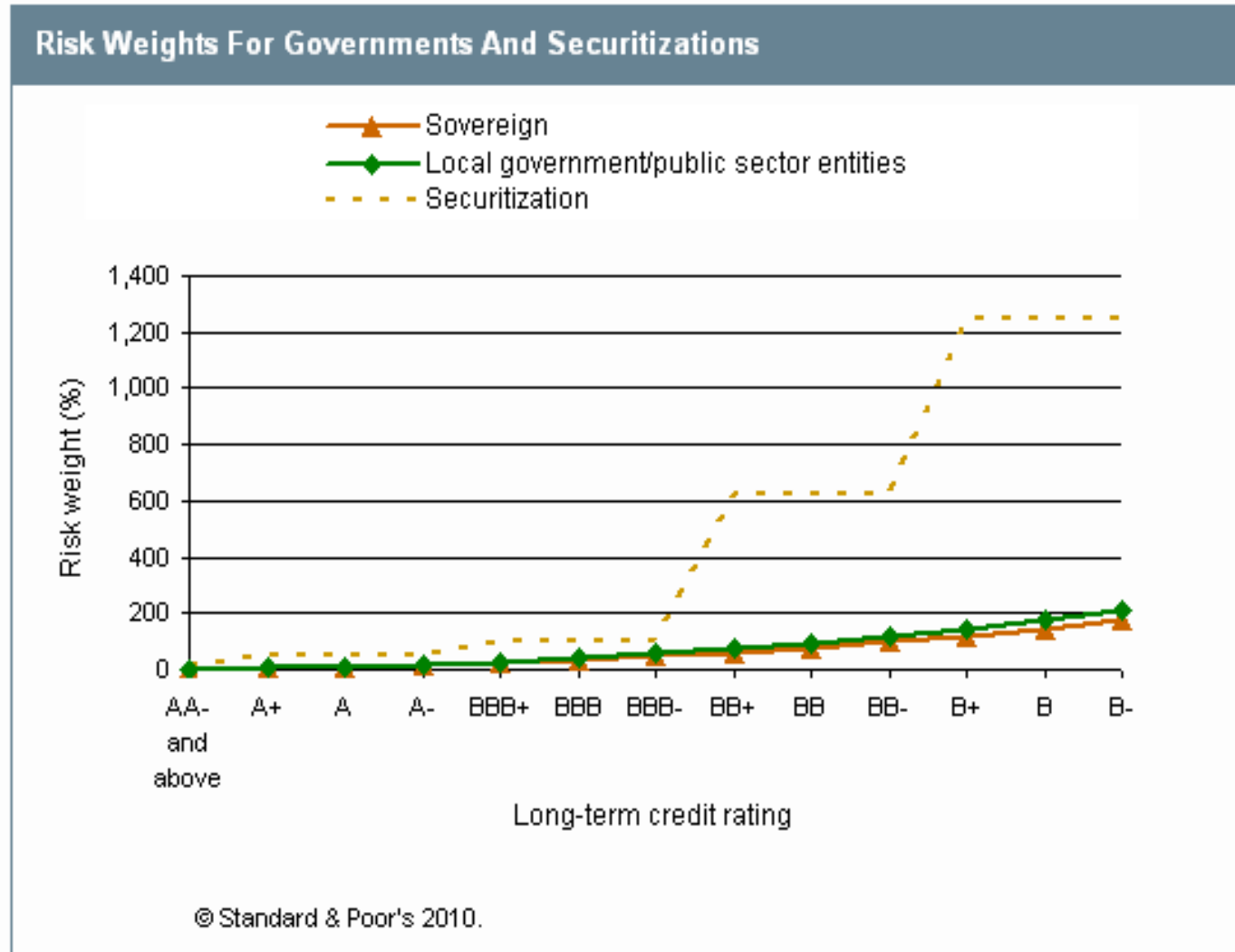
S&P Risk Weights For Corporate And FI Exposures



S&P Risk Weights For Retail Exposures

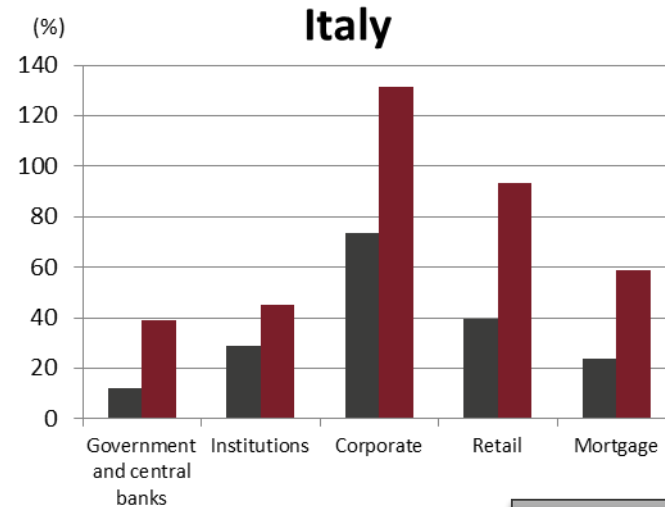
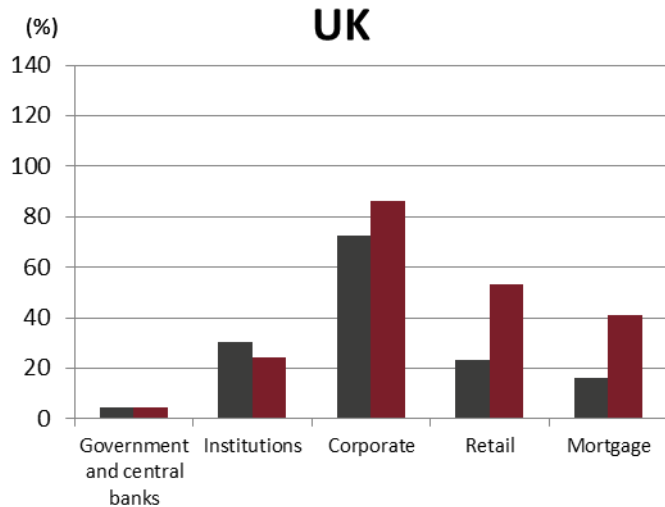
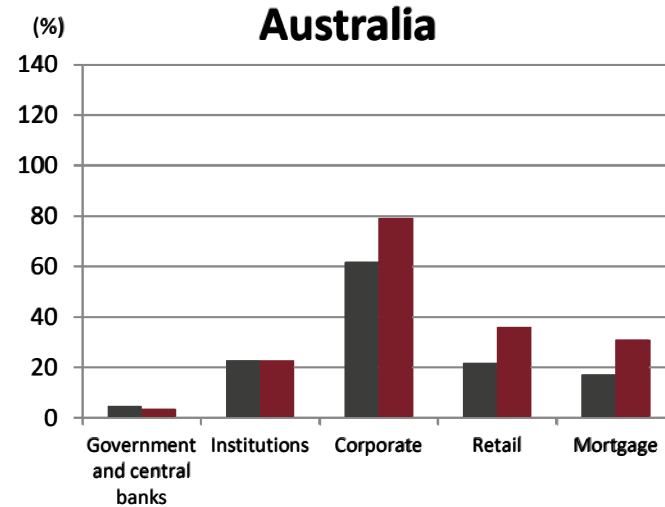
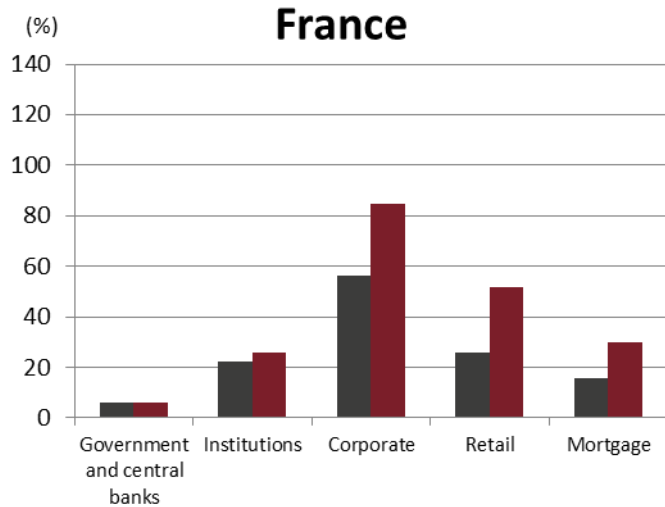


S&P Risk Weights For Sovereign And Securitizations



Appendix 2: Regulatory RWs vs S&P RWs – Illustrative Example

Regulatory RWs vs S&P RWs – Illustrative Example



Copyright © 2016 by Standard & Poor's Financial Services LLC. All rights reserved.

No content (including ratings, credit-related analyses and data, valuations, model, software or other application or output therefrom) or any part thereof (Content) may be modified, reverse engineered, reproduced or distributed in any form by any means, or stored in a database or retrieval system, without the prior written permission of Standard & Poor's Financial Services LLC or its affiliates (collectively, S&P). The Content shall not be used for any unlawful or unauthorized purposes. S&P and any third-party providers, as well as their directors, officers, shareholders, employees or agents (collectively S&P Parties) do not guarantee the accuracy, completeness, timeliness or availability of the Content. S&P Parties are not responsible for any errors or omissions (negligent or otherwise), regardless of the cause, for the results obtained from the use of the Content, or for the security or maintenance of any data input by the user. The Content is provided on an "as is" basis. S&P PARTIES DISCLAIM ANY AND ALL EXPRESS OR IMPLIED WARRANTIES, INCLUDING, BUT NOT LIMITED TO, ANY WARRANTIES OF MERCHANTABILITY OR FITNESS FOR A PARTICULAR PURPOSE OR USE, FREEDOM FROM BUGS, SOFTWARE ERRORS OR DEFECTS, THAT THE CONTENT'S FUNCTIONING WILL BE UNINTERRUPTED OR THAT THE CONTENT WILL OPERATE WITH ANY SOFTWARE OR HARDWARE CONFIGURATION. In no event shall S&P Parties be liable to any party for any direct, indirect, incidental, exemplary, compensatory, punitive, special or consequential damages, costs, expenses, legal fees, or losses (including, without limitation, lost income or lost profits and opportunity costs or losses caused by negligence) in connection with any use of the Content even if advised of the possibility of such damages.

Credit-related and other analyses, including ratings, and statements in the Content are statements of opinion as of the date they are expressed and not statements of fact. S&P's opinions, analyses and rating acknowledgment decisions (described below) are not recommendations to purchase, hold, or sell any securities or to make any investment decisions, and do not address the suitability of any security. S&P assumes no obligation to update the Content following publication in any form or format. The Content should not be relied on and is not a substitute for the skill, judgment and experience of the user, its management, employees, advisors and/or clients when making investment and other business decisions. S&P does not act as a fiduciary or an investment advisor except where registered as such. While S&P has obtained information from sources it believes to be reliable, S&P does not perform an audit and undertakes no duty of due diligence or independent verification of any information it receives.

To the extent that regulatory authorities allow a rating agency to acknowledge in one jurisdiction a rating issued in another jurisdiction for certain regulatory purposes, S&P reserves the right to assign, withdraw or suspend such acknowledgment at any time and in its sole discretion. S&P Parties disclaim any duty whatsoever arising out of the assignment, withdrawal or suspension of an acknowledgment as well as any liability for any damage alleged to have been suffered on account thereof.

S&P keeps certain activities of its business units separate from each other in order to preserve the independence and objectivity of their respective activities. As a result, certain business units of S&P may have information that is not available to other S&P business units. S&P has established policies and procedures to maintain the confidentiality of certain non-public information received in connection with each analytical process.

S&P may receive compensation for its ratings and certain analyses, normally from issuers or underwriters of securities or from obligors. S&P reserves the right to disseminate its opinions and analyses. S&P's public ratings and analyses are made available on its Web sites, www.standardandpoors.com (free of charge), and www.ratingsdirect.com and www.globalcreditportal.com (subscription), and may be distributed through other means, including via S&P publications and third-party redistributors. Additional information about our ratings fees is available at www.standardandpoors.com/usratingsfees.

Australia

Standard & Poor's (Australia) Pty. Ltd. holds Australian financial services license number 337565 under the Corporations Act 2001. Standard & Poor's credit ratings and related research are not intended for and must not be distributed to any person in Australia other than a wholesale client (as defined in Chapter 7 of the Corporations Act).

STANDARD & POOR'S, S&P and RATINGSDIRECT are registered trademarks of Standard & Poor's Financial Services LLC.