IRISH BANKING FEDERATION

IBF SUBMISSION TO CENTRAL BANK CONSULTATION ON

IMPACT METRICS FOR THE RISK BASED SUPERVISION OF FINANCIAL FIRMS AND IMPACT BASED LEVIES

1. Introduction

The Irish Banking Federation (IBF) welcomes the opportunity provided by the Central Bank of Ireland (CBI) to discuss and comment on this consultation paper and to input to determining the factors which will influence the future focus of supervision and so the level of fees to be raised by the Central Bank.

We offer some overall observations initially, then general comments on the paper and finally answer the questions raised, where relevant.

2. General Observations

IBF bank members welcome a simplified approach to this topic. If a high level of portfolio analysis were to be considered this could make the approach too complex. Equally the risk based approach to both supervision and to the levy is a welcome and practical framework.

We understand that few new metrics or additional information gathering will be necessary in conducting this exercise and that existing data sources will be used as far as possible. We welcome this consideration.

In its title, the consultation paper refers to “Risk Based Supervision”, yet this risk element appears to be absent here. In figure 2-3, Impact and Probability combine to give Supervisory Prioritisation, yet probability is absent from the discussion throughout the paper.

The paper addresses the impact aspects only. We believe that trying to measure impact is insufficient and leads to a weakness in the proposed model. <u>Risk</u> is the <u>likelihood</u> of a specific event of <u>known</u> impact occurring, in a given <u>time frame</u>. All three issues are interdependent, most obviously with tail risks which have a very high impact but very low likelihood of occurrence. High impact risks consequently should have low likelihood of occurrence. There is no discussion in the paper of the probability / likelihood metrics and how they might be derived. We see this element as equally important in determining the overall supervisory framework. We consider that it will be necessary to review the final framework combining the risk elements with the prioritised impact approach to get an appropriate overview. In fact some assessment of risk elements precedes the impact measure, as high-level risk management can prevent the occurrence of a trigger event occurring or having an impact. We indicate in Question 4 some measures that might incorporate risk elements.

Obviously the level of supervisory prioritisation will not be a standalone measure derived from this consultation. It must link to the on-going supervision and line management inputs that arise from the regular CBI interaction in reviewing the overall risk profile of an institution, e.g. from ICAAP submissions and SREP visits.

In Section 3.2, the Paper states “The Central Bank’s provisional preference is to use a simple average or weighted average of the impact scores to ensure that, for all categories of firm for which it is pertinent, a combination of prudential and consumer focused metrics influence the overall impact score a firm receives.” This statement appears contrary to the concept of risk prioritised supervision. By focusing on an average, in what is clearly a dynamic environment, the most critical risks could well be masked from supervisory oversight. It is better to consider the largest impact score(s) than the average - at least it is then clear where "priority" emerges from.

<u>Divisors</u>: We understand that the purpose of a divisor is to normalise or base line the same metric for different regulated entities. We need to understand the sources being considered for divisors. However, the Paper does not explain how the illustrative divisors are determined or the basis for normalisation.

For example in Figure 3.1, we suggest that it would be more practical to show the impact of €700m over a divisor of the number of customers. Assuming 50,000 customers, this would give an impact of €14,000 per customer whereas 5,000 customers give an impact of €140,000.

It is important that the divisor measures the true scale of risk, not simply the scale. Useful divisors could be e.g. number of customers, capital held, deposits etc. as that ratio would illustrate the spread of the risk. However we are unsure if this is how these metrics will be determined.

It is not clear if the impact is being assessed in the State only or how the global economy impact can be considered. Clarity would be appreciated.

The view of IBF members is that liabilities are the primary element to be considered in determining the impact, or the size or ability of a credit institution to cause prudential harm or customer loss.

The paper seeks to establish a quantitative framework for fee setting. However we consider it would need the input of CBI information in many aspects for accuracy in establishing this quantitative framework.

A further question arises for an institution spread across several categories, in particular with a significant secondary business. We understand normalised impact scores will be combined to give an aggregate impact score. However probability must equally be part of the equation.

The concepts and thought processes of the paper are at times conceptual. Ideally we consider that a draft practical example, by institution, of the potential metrics would improve understanding and subsequent commentary. As we understand this approach is unlikely, with supervisory prioritisation likely to be determined by year end, a review after three years of implementation should be undertaken to ensure the new approach is appropriate.

No matter what impact metrics are chosen, there should be a clear linkage apparent to all interested parties as to how they relate to recent experience.

3. Comments on the Paper

We are at times confused by the messages being given by the paper. Some examples follow.

The definition of Impact varies between the various references, e.g. in paragraph 2.2, figure 2-1 and figure 2-3. We were unsure which to work with. We have focused on the paragraph 2.2 definition – “size or ability to cause prudential harm or customer loss.”

In considering systemic risk, we should distinguish between systemic risk resulting from the failure of an entity within the jurisdiction and systemic risk deriving from the global interconnectedness of financial systems, e.g. a market crash, a war that disrupts key resource supplies such as oil or a recessionary event of a magnitude such as a Lehman’s failure. The goal should be to control the former but to recognise that no amount of supervision at national level can pre-empt the latter.

In relation to paragraph 2.4, we query the statement that probability ratings are concerned with “the likelihood of a firm having an adverse effect on the Central Bank’s objectives”. In risk management terms, probability is the likelihood of a particular risk arising.

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4. Questions Posed

Question 1 *Of the different approaches to the calculation of impact scores do you have a view as to which method is preferable and why?*

The IBF considers this a matter to be determined by the Central Bank based on practical experience. The divisors are more likely to be determined by the Central Bank based on its own statistical analysis, rather than by banks which would not be able to make such fully informed decisions. However further explanation of the basis for divisors, how they are determined and their purpose would be welcome to make a more informed comment.

The approach outlined gives only a broad framework or format but we consider the addition of objectivity would be required, probably based on CBI industry knowledge.

Question 2 *The Central Bank will clearly have to make judgements when deciding what divisors to apply to each impact metric in order to devise a set of impact scores which are correctly calibrated. Do you wish to suggest mathematical processes which the Central Bank should apply to ensure that it calibrated impact scores across sectors appropriately?*

The divisor should be reflective of the level of risk implicit in the overall metric. Consequently it should either benchmark against the average for the sector in the jurisdiction or across the EU, and/or be reflective of the qualifying aspect of the risk, e.g. the total deposit book with a divisor of the total number of depositors. Divisors should be either a) appropriate benchmarks for the impact being assessed, or b) factors which provide a balanced view of the scale of the risk e.g. how widely it is spread.

However ideally industry would need to have a greater understanding of the basis for the divisors, e.g. how are they to bring comparability across metrics or sectors? How will they operate as a weighting mechanism for different metrics?

Again we consider we need greater clarity on the qualitative factors being considered as part of the probability rating before being able to comment more meaningfully here.

Question 3 *Do you regard the Central Bank's plan to use impact metrics as a major determinant of the levies firms pay as fair? If not, why not?*

We agree with a transparent and measurable risk-based approach, using probability-weighted impact metrics. However we consider the mechanism involved requires further elaboration to fully understand the consideration, as the probability element is not elaborated on in the paper.

In addition, the approach must be balanced to reflect not just impact but also the quality of governance of risks i.e. the effectiveness of the control environment - otherwise it acts as an absolute break on economic development (i.e. taking risks).

On a separate point, institutions that operate in Ireland on a branch basis, and which are primarily regulated by an EEA supervisor for prudential requirements, consider that their main levy applied should be the Irish consumer levy. It would be unreasonable for them to contribute in any significant manner to levies for local prudential supervision, with which they have minimal involvement.

a) *Would you favour phasing in the changes in the weight of the net annual funding requirement attaching to different industry categories, should the introduction of levy setting by impact score alter the current balance of the net annual funding requirement between different industry categories?*

We understand that banks should currently be relatively well categorised and that no major change in supervision category is anticipated. However any significant changes should carry some advance notice, especially an increase in levies / supervision.

We suggest an opportunity to understand and review the impact of the actual proposals would be worthwhile. Ideally a dry run of the proposed approach might have been undertaken, giving for example the likely outcome that would have arisen for the past three years. The CBI could then allow for further consultation on an individual basis and feedback before finalisation. Impact and probability aspects would need to be identified separately.

This approach might still be considered when the probability rating is being addressed. Otherwise a review three years into implementation would be worthwhile, to see if the desired balance is achieved.

Question 4 *Do you think the impact metrics set out in Section 6 above are the appropriate impact metrics for each type of firm? Which two or three would you attach the greatest importance to in each firm category?*

Different metrics will obviously apply to different types of institution, based on their varying business models, structures, activities etc. We outline below what we consider are the relevant ones for the various business models represented by the IBF.

<u>Category A, Credit Institutions</u>:
IBF members consider liabilities as the key impact metrics, for A1a, A1b and A3. Assets should primarily feature in determining the probability rating.

The following liabilities should, where relevant, be used to determine the impact rating:

1. State guarantee deposits under the ELG scheme
2. Retail deposits, insured under DGS or its equivalent in another EU country
3. Other deposits
4. OTC Derivative counterparty balances determined in accordance with CRD collateral and netting rules
5. Secured Senior Debt
6. Unsecured Senior Debt
7. Wholesale funding to deposit ratio

As already referred to above, we note that risk measures are not yet incorporated in this approach. We have elaborated on our view that the consultation is incomplete without them. For future consideration, some indicators which could be factored into the overall assessment of risk include:

- Arrears (loans, mortgages) as a proportion of the book, to determine the stability of the funds raised
- Risk capital allocation by area e.g. market, credit, operating, liquidity etc
- Overall risk capital

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We agree in category A2 (credit institutions authorised in another EEA state and operating in Ireland on a branch basis) that group aspects, for example group credit rating, should be considered as part of the risk probability assessment and so would contribute to determining the supervisory prioritisation and levies.

For branches which may only be retail deposit takers in the Irish market, we consider that the most relevant metrics would be:

- Retail deposit base
- Number of products
- Number of customers

<u>Category D3 - Portfolio Management</u>: Assets under management or administration

<u>Category E2b - Trustees</u>: Assets under management

<u>Category J1 - Bureaux de Change</u>: Money throughput

<u>Category N - Payment Institutions</u>: Money throughput

Question 5 *What other impact metrics should the Central Bank considers using for different types of firm?*

As outlined in Question 4, under A2 - branch operations, Group aspects, such as the Group credit rating, should be a significant element of the risk probability assessment, and so influence the supervisory prioritisation and levies.

Question 6 *Should the Central Bank attach equal importance to the alternative impact metrics for different firm types you discuss in your responses to Q4 and Q.5 above or should it attach more weight to one or another metric? If so, which ones?*

The divisors are important here but it is not yet clear how these might be determined. If the divisors can normalise the impact across different variables, then the relative importance of each should be determined. How will the Central Bank determine these divisors?

Question 7 *Should wholesale firms have different impact metrics from retail firms focused on consumers.*
7.1 If so why?
7.2 If so, what should differ?

We consider that the liabilities framework above therefore addresses this and the relative exposure locally of each subcategory.

Question 8 *Are there categories of firm above missing which you would expect to see covered separately?*
8.1 If so, what?
8.2 If so, what metrics should the Central Bank use?

None considered missing.

Question 9 *Are there any impact metrics and divisors above, which, whilst they might be helpful for firm supervision, would be inappropriate for allocating a firm to fee block?*
9.1 If so, why?

Again we would appreciate more clarity on the determination divisors and their use to enable us to better answer this question.

The main focus should be on the impact of a firm's failure based on its liabilities. The probability metrics should take into account aspects such as the number of customers etc. Equally capital ratios and liquidity aspects should be incorporated through the probability inputs.

Question 10 *In terms of category of firm, should the Central Bank consider sub-dividing some of the firm types above and applying different divisors to different types of firm?*
10.1 If so, which firms?
10.2 If so, what divisors?
10.3 What would be the logic for the sub division?

We consider firms can readily categorise themselves under the given headings. As before, greater clarity on the process of determining divisors would be appreciated. Again, the qualitative probability features come to the fore, e.g. the weighting of short-term less stable funding as opposed to long term stable funding.

We would be pleased to elaborate further on these views with you.

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