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Developments in regulatory frameworks: implications for risk management

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Key messages

1 Banking Union is a useful step; but even if credible and completed, will not eliminate sovereign-bank linkages

2 IFRS 9 is a welcome step; but credibility of the standards will depend on consistent application

3 Ratings should not be used in regulation

Banking Union: broad credit impacts

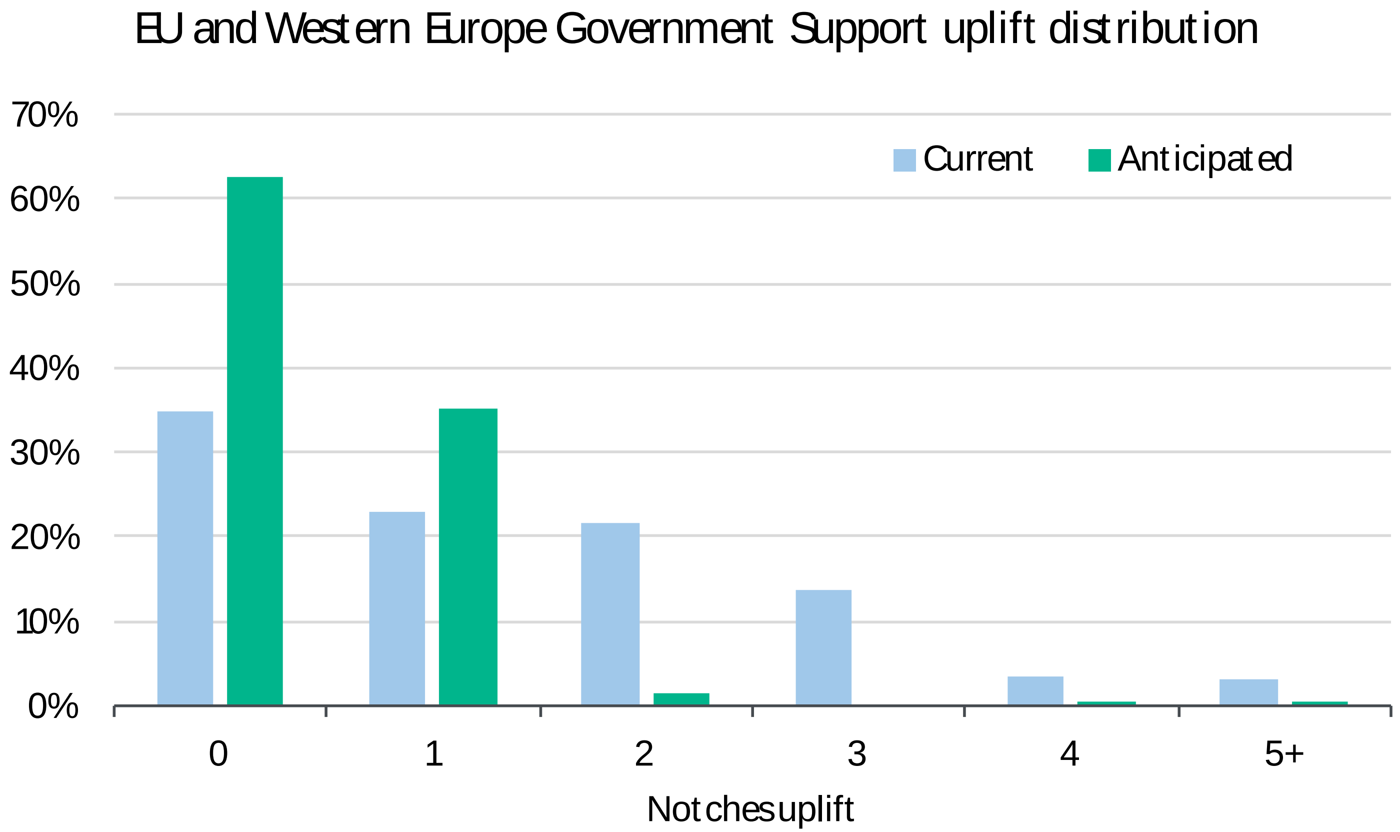
- Single supervisory mechanism (SSM) should ensure greater consistency of treatment for (larger) banks
  - But national discretion still plays a role
- Single resolution mechanism (SRM) should ideally provide clarity around future treatment and a credible common backstop for bank failures
  - Resolution of different banks over time critical to establish credibility
  - Does it fully break linkages between sovereigns and banks?
- European deposit insurance scheme (EDIS) would ‘complete’ the banking union
  - Implies a degree of fiscal mutualisation, first step towards full EMU

- **Credit positive:** stronger & more consistent supervision should uncover and resolve nascent issues more swiftly
- **Impact on different instruments is mixed:** introduction of BRRD and (hoped for) clarity over resolution has reduced sovereign support and increased likelihood that junior instruments will bear losses. Senior creditors broadly neutral & depositors modestly positive, given lower loss rates in orderly resolution & subordination

Gov’t support in bank ratings

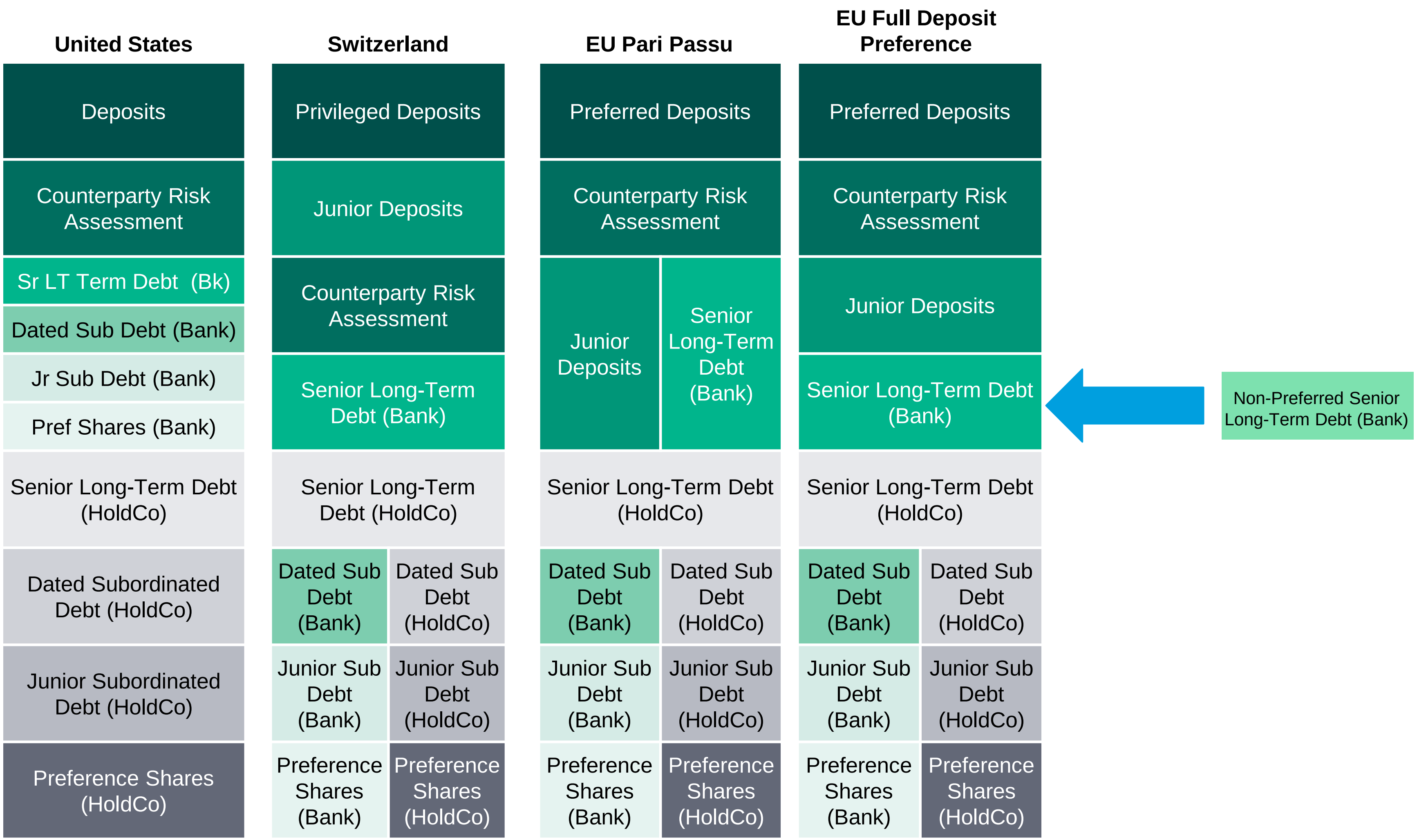
Support declined materially with uplift of more than one notch rare

» New approach took BRRD at its word



Note – chart shows 2015 expectation of support following new methodology roll-out

MREL loss absorption & LGF analysis



Source: Moody's Investors Service

Europe’s First High-Trigger AT1 Collapse - Banco Popular’s CoCos Wiped Out

Credit Neutral for AT1 Market	Absorbed losses as planned. But credit positive for senior debt, sparing senior creditors from loss.
Early intervention	An important example of modern regulatory framework in action and how the asset class could be impacted in practice.
All CoCos equally affected	No distinction between the treatment of high and low trigger CoCos. Bears out the approach we take when rating.
Lack of subordination	Demonstrated the limited differential in risk faced by the various junior creditor classes where the volume of each class is a small proportion of the overall liability structure.
Limited Contagion	Does <u>not</u> imply any increase in the likelihood of Bank high-trigger CoCos being triggered as part of a resolution process.

Resolution of Popular by SRB a positive step for EU resolution regime

Treatment of Italian banks raises questions about authorities commitment to full bail-in of senior creditors…

…the approach to Popular was squarely in line with Bank Recovery & Resolution Directive

Broader lessons less certain

Illiquidity or Insolvency

Willing buyer

MREL & TLAC not yet in place

BRRD not intended for legacy issues

Bail-in a reality in EU:

Banco Espirito Santo /

Novo Banco / Popular

But inconsistent treatment of senior creditors still drives uncertainty – Montepaschi, Veneto, Vicenza

Despite growing questions, most banks expected to be resolved without government support

Senior creditors of systemically important banks - moderate support (1 notch)
HoldCo & Junior creditors low / no support

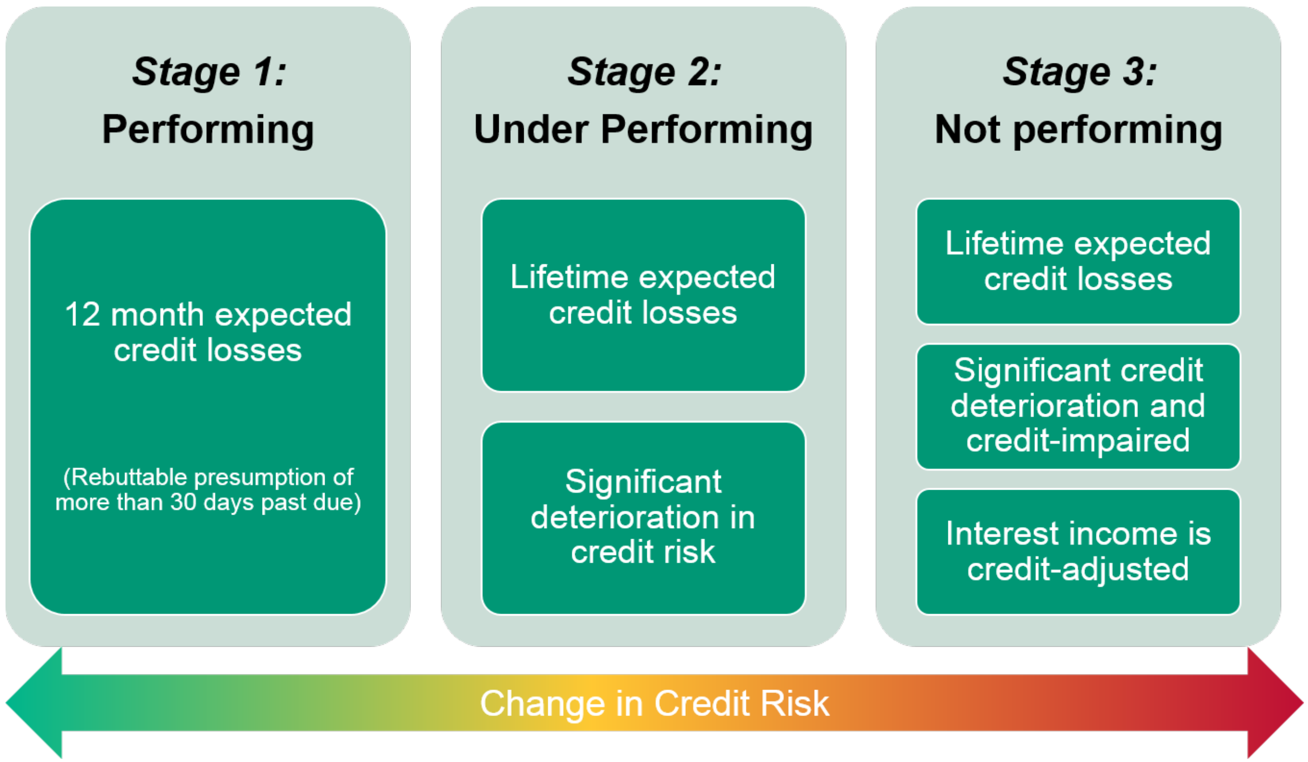
But questions remain….

- Are taxpayers still likely to be on the hook for some entities?
  - Do political considerations play an undue role?

- Even if credibility is established at the idiosyncratic level, BRRD matters more for banks than sovereigns
  - ‘Extraordinary systemic stress’ allows public support instead of imposing losses in full on private creditors
- Macroeconomic linkages and shock transmission channels will still persist, even if banks’ sovereign exposures are addressed
- We view sovereign credit as having pervasive effects on domestic issuers

Accounting changes: IFRS9

- Differences in application of accounting standards are a major issue for rating agencies
- Goals of IFRS9 are well understood & welcome



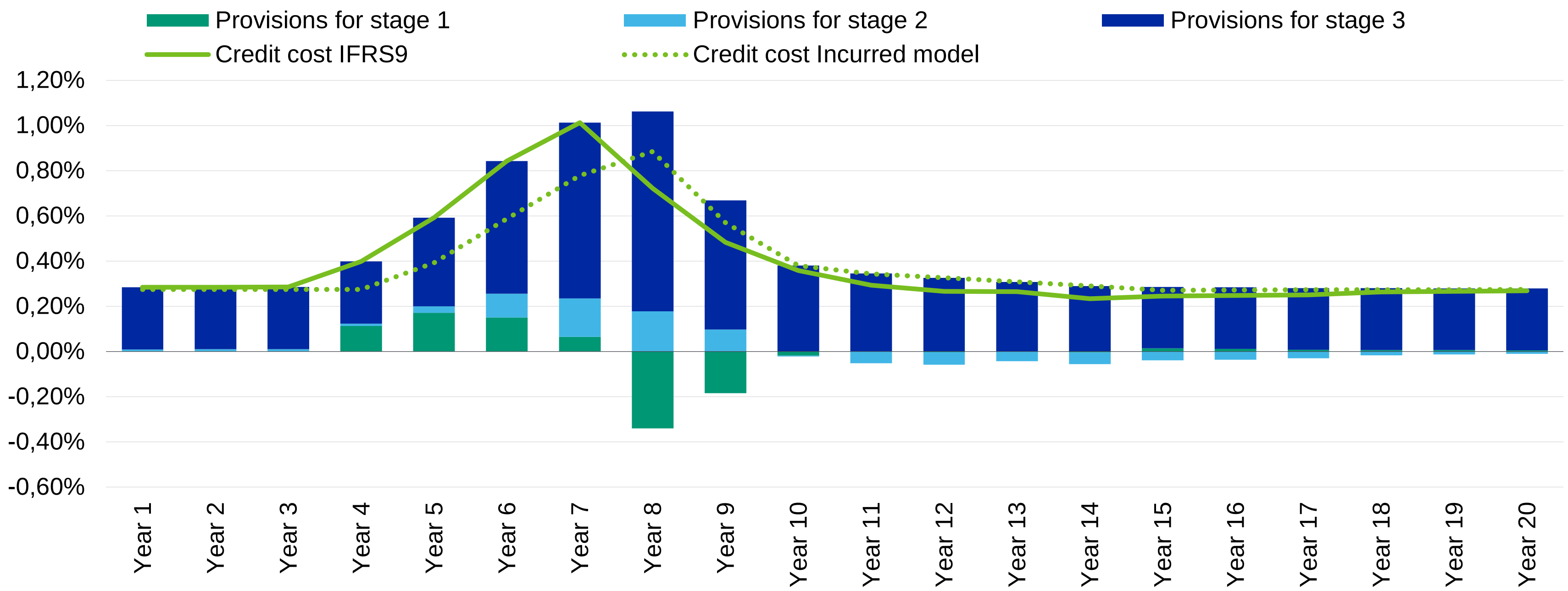
Moody's Survey of Banks: Key Findings

- Capital: Most banks (87%) believe CET1 ratios will decrease by a maximum of 50 bps. We believe that in most cases, existing capital buffers should be able to absorb this impact.
- Loan Loss Reserves: Residential mortgage and consumer loans will see the most significant increase in loan loss reserves. For other loan types, banks believe reserves on the balance sheet will generally increase by up to 10%.
- Provisions Volatility: Almost 70% of banks believe provision expenses on the income statement will be more volatile from period to period. This is due to the 'cliff effect' of moving between 12-month ECL and lifetime ECL as well as the incorporation of forward-looking information.
- Business Profiles: Banks do not believe they will need to adjust their business profiles. However, banks do expect to adjust loan pricing to reflect the upfront reduction in capital.
- Implementation Status: About half of banks are still in the early stages of implementation; 8% have not yet started. For these banks, time available for implementation is compressed, which may compromise the quality and comparability of measurements
- Early Disclosures: 50% of banks are planning to provide information on the impact of IFRS 9 in financial statements prior to 2018.

For more information see: Global Banks -Moody's Survey: Capital Impact of IFRS 9 Adoption Will Be Modest For Most Banks

Expansion and recession: IFRS 9 vs incurred model

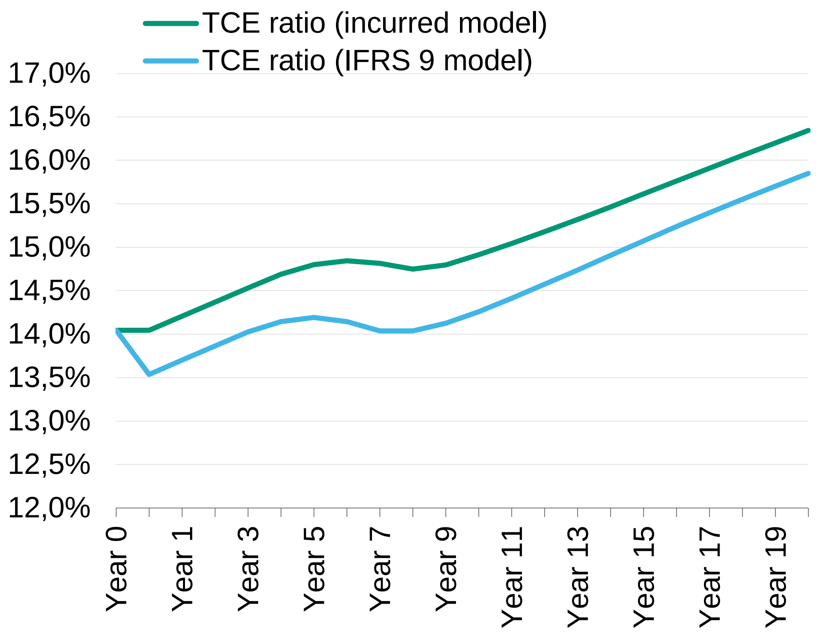
Breakdown of loan provisions (income statement)



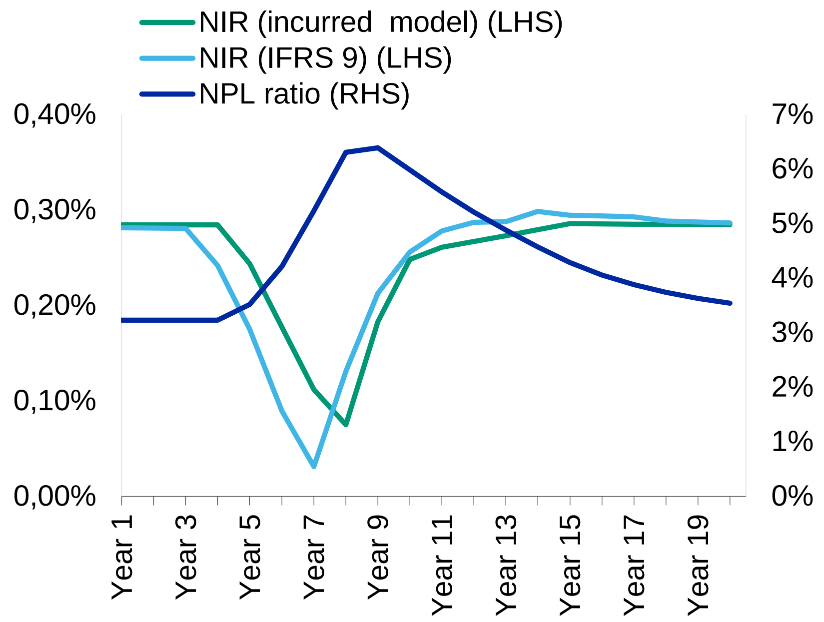
- S1 loans drive the initial increase in provisions, ahead of the recession. S2 provisions increase when the portfolio actually deteriorates (cliff effect from S1 to S2 loans).
- Provisions are released earlier in the cycle, with the expectation of a recovery.

Expansion and recession: IFRS 9 vs incurred model

Simulation of TCE ratio under both models



Simulation of net income ratio under both models



- Capital ratio declines earlier in the cycle. Net income starts to fall one year prior to in the incurred loss accounting model.
- Under IFRS 9, loss-absorbing capacity is higher and the recovery is also more rapid - banks will be in a stronger position to support growth as the economy recovers.

Conclusions from our modelling work

» Initial impact of IFRS9 will be limited for most banks
  – Around 50bps on TCE
  – Difficult to believe ‘weak’ banking systems will see as limited an impact as ‘strong’ systems
  – But significant uncertainty here, particularly around (starting) structure of the loan portfolio
  – Essential that regulatory treatment is consistent across countries

» After implementation, credit costs in steady state will be marginally higher and, conversely, net income marginally lower.

» During a downturn, banks will increase reserves and coverage ratio earlier in the cycle, a credit positive.

» For more information see: IFRS 9 will help banks cope with loan losses but have larger initial costs in weak systems

Credit ratings: tools for investors

- Ratings are forward-looking opinions of the relative credit risks of financial obligations
  - Risk of default, including distressed exchanges
- Uncertainty is inherent; ratings cannot be ‘statements of fact’
- Our aim is to help investors; ratings facilitate communication about credit risk, irrespective of industries or geographies
  - Promote a shared understanding of credit risk

BUT

- There is more than one type of rating!
- Ratings are only one of many tools used by private sector investors
  - Ultimately, they can – and do – form their own perspective
  - Ratings are used in different ways, as the user deems appropriate
- Mechanistic use of ratings, for instance in regulation, is not appropriate
- Any shift aimed at limiting analytical thought & judgment will not generate ratings

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KANGANEWS AWARDS 2016

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ASIAN AWARDS 2017 THE ASSET TRIPLE A

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ASIAMONEY BEST CREDIT RATING AGENCY 2016

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