



# **Trust Bank**

## **A Case Study on Risk-based Supervision**

• (Views expressed in the case study do not necessarily reflect those of the BIS or the Basel Committee)



## Outline

- Trust Bank: An Introduction
- Trust Bank: An Assessment of Risk Profile
- Your Tasks and Suggested Topics for Discussion



## Trust Bank: Risk Profile and Capital Requirements

- Trust Bank is one of the largest banking institutions in Trustland
- Trust Bank performs a detailed assessment of its risk profile and capital requirements on an annual basis. The information below summarises the assessment for the year-end 2050:

Total assets	€ 88.0 billion (bn)
Net income	€ 1.02 bn
Tier 1 capital	€ 6.81 bn
Tier 2 capital	€ 4.22 bn
Basel I Tier (1) ratio	6.89%
Basel I Tier (1+2) ratio	11.17%
Basel II Tier (1) ratio	7.19%
Basel II Tier (1+2) ratio	11.63%
Economic capital	€ 5.22 bn



## Trust Bank: Peer Banks Analysis

	Trust Bank	Bank One	Bank Two	Bank Three
Total assets	€88.0 bn	€95.6 bn	€85.1bn	€100.0 bn
Net income	€1.02 bn	€1.5 bn	€0.7 bn	€1.1 bn
Available Tier 1 capital	€6.81 bn	€8.0 bn	€5.0 bn	€10.0 bn
Available Tier 2 capital	€4.22 bn	€4.0 bn	€2.5 bn	€3.0 bn
Basel I Tier (1+2) ratio	11.17%	10.85%	10.00%	10.5%
Basel I Tier (1) ratio	6.89%	6.5%	5.9%	6.5%
Basel II Tier (1+2) ratio	11.63%	11.1%	10.5%	10.9%
Basel II Tier (1) ratio	7.19%	7.0%	6.5%	6.9%
Economic capital (EC) of which	€5.22 bn	€4.8 bn <sup>[1]</sup>	€4.5 bn <sup>[2]</sup>	€5.9 bn <sup>[3]</sup>
• Credit risk (CR)	€2.90 bn	€2.3 bn	€2.7 bn	€3.2 bn
• Market risk (MR)	€1.64 bn	€1.5 bn	€1.1 bn	€2.0 bn
• Operational risk (OR)	€0.91 bn	€0.8 bn	€0.7 bn	€0.5 bn
• Diversification benefit across CR, MR and OR	(€0.75 bn)	(€0.4 bn)	-	(€0.6 bn)
• Sub total CR,MR and OR	€4.7 bn	€4.2 bn	-	€5.1 bn
• Business risk (BR)	€0.52 bn	€0.6 bn	-	€0.8 bn

<sup>[1]</sup> Bank One assumes diversification benefit between credit, market and operational risk in computing economic capital.

<sup>[2]</sup> Bank Two assumes no diversification benefit in computing economic capital and does allocate EC for business risk.

<sup>[3]</sup> Bank Three assumes diversification benefit between credit, market and operational risk in computing economic capital.



## Trust Bank: Risk Profile and Capital

Trust Bank is of the view that-

- Regulatory capital ratios show sufficient and flexible buffers in the context of Basel II and they seem to be better aligned with its risk profile and corresponding economic capital
- The governance and risk processes are state of the art and in line with the requirements outlined in the more advanced approaches under Basel II
- The Bank operates in a competitive environment and continues to perform well compared to its peers



## Your Task

- Assess strengths and weaknesses of Trust Bank's risk management systems
- Working in groups, you are kindly asked to focus on the following key areas of Bank's functioning:
  - Governance and risk management process
  - Credit Risk including Credit Concentration risk
  - Market Risk
  - Interest rate risk in the banking book
  - Liquidity risk
  - Operational risk
  - Risk appetite and capital assessment
  - Capital planning and stress testing
  - Overall Risk Profile of Trust Bank and Supervisory Approach



## Your Task

- In order to make your group work more efficient, you may want to consider
  - Dividing topics among your team members
  - Keeping one person responsible for coordinating and overseeing your group's response
- In analysing the Trust Bank's risk profile, you may want to highlight
  - Strengths
  - Weaknesses
  - Supervisory/Prudential perspective
- Any group may be called upon to present its analysis on any one of the areas suggested before



## **Governance and Risk Management Process - Suggested Discussion Points -**

- How would you assess the overall governance structure at Trust Bank given its risk profile, current operating environment and business strategy?
- Would you consider that the roles and responsibilities of the board and senior management at Trust Bank are clear and transparent?
- What would be your opinion about Trust Bank's board involvement in setting the bank's risk appetite, assessing the level of risk, relating it to adequate levels of capital and monitoring compliance with internal policies?
- Would you consider appropriate the system for monitoring and reporting risk exposures and capital needs to the Board and Senior Management?





## **Credit Risk including Credit Concentration Risk - Suggested Discussion Points -**

- How do you assess the overall credit risk profile of the Bank in terms of the level and direction of credit risk
- What is the importance you would assign to credit concentration risk in general and name concentration risk versus sector concentration risk in particular?
- Would you require the bank to submit more information than what is given in the case study? If yes, please list what more information you would like to have?



## Market Risk

- How do you assess the overall market risk profile of the Bank in terms of the level and direction of market risk
- What is your assessment of the market risk measurement technique employed by the bank?



## **Interest Rate Risk in the Banking Book (IRBB) - Suggested Discussion Points -**

- How would you assess the IRBB management framework applied by Trust Bank?
- What is your opinion about the methodology used by the bank to measure its interest rate risk exposures in the banking book?
- Are you comfortable with the maturity mismatch assessment implemented by Trust Bank?



## **Liquidity Risk**

### **- Suggested Discussion Points -**

- How would you assess the overall liquidity risk of Trust Bank in terms of its level and direction?
- How effective do you find Trust Bank's intraday and short-term liquidity strategy?
- In light of the latest developments in the financial markets, would you consider appropriate the approach that Trust Bank is taking for having liquid assets and diversified liquidity sources?
- Are you comfortable with the stress testing technique applied by Trust Bank?



## Operational Risk

- How do you assess the overall market risk profile of the Bank in terms of the level and direction of market risk
- Would you require the bank to submit more information than what is given in the case study? If yes, please list the additional information you would like to have?



## **Risk Appetite and Capital Assessment - Suggested Discussion Points -**

- How would you assess Trust Bank's approach to setting its risk appetite?
- What is your opinion about the capital assessment process at Trust Bank? Do you think this assessment (particularly its economic capital) captures all material risks to which the bank is exposed?
- Would you consider that Trust Bank's regulatory risk based capital ratios are appropriate considering the bank's exposures?



## **Capital Planning and Stress Testing - Suggested Discussion Points -**

- How would you assess the capital planning approach taken by Trust Bank to ensure that the capital management objectives are met over the medium and long term? Do you find this approach sufficiently forward looking?
- As part of the capital planning process, the bank uses scenario analysis as its primary stress test tool for Pillar 2 risks. Are you positive about the way this tool is implemented in the bank?
- How would you assess the reverse stress test carried out by the bank? Should reverse stress test feed into the capital planning process?
- Are you comfortable with the management actions undertaken by Trust Bank as a result of its stress testing exercises? Would you require the bank to raise additional capital based on the stress testing projections?



## Overall Risk Profile of Trust Bank

	Level and Trend of Risk									and Risk Management	Governance	Capital Planning and Capital buffers	Risk Appetite
	Low			Medium			High						
	→	↑	↓	→	↑	↓	→	↑	↓				
Credit Risk (including credit concentration risk)													
Market Risk													
IRRBB													
Liquidity Risk													
Operational Risk													
Business Strategy													
Bank's Overall Risk Profile													





## Supervisory Approach

- Given trust Bank's overall risk profile taking into account its risk governance and risk management systems, what is the supervisory approach you will adopt in terms of –
  - The frequency and intensity of on-site supervision
  - Recommendations to the bank management, if any
  - Additional information requirements from the bank, if any



# **Trust Bank A Case Study on Risk-based Supervision**

• (Views expressed in the case study do not necessarily reflect those of the BIS or the Basel Committee)