IFRS9 and Capital Management

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Agenda

1. Current Economic Climate
2. IFRS9
3. Capital Management
4. Holistic Risk Capabilities
5. Best Practices and Solutionisation

Banks are under Pressure

12%

Expected RoE

Profitability of Banks is at the highest since the Global Financial Crisis.

In comparison RoE in 2020 was just below 8%.

70%

Valuation Gap

The banking industry trades at a 70% discount to the broader economy. Half of that is driven by the low growth outlook.

€52bn

Estimated capital gap post Basel IV

European banking system would have to raise an additional 52bn of capital based on current lending volumes.

Source: McKinsey's Global Banking Annual Review, December 2022; Economist Banking in 2035: global banking survey report

Current Economic Environment

Banks face a number of different challenges, most of them driven by the current economic climate that puts substantial pressure on key drivers for RoE, Market CAP and growth opportunities:

- Regulatory Pressure
- Economic Climate
- New emerging Risks
- Managing Volatility

Geopolitical Risks

The lasting effects of COVID and impact on supply chains, the lasting conflict in Ukraine and slowing economy as well as inflation remaining high will lead to deteriorating loan quality.

01

Regulatory Pressures

Basel IV finalization will lead to reduced risk sensitivity of capital. Bigger impact on Europe expected due to wider use of internal models resulting in larger Tier 1 capital buffer.

02

Volatility

Geopolitical risk, Basel IV and Emerging risks all contribute the increased volatility that institutions observe and need to manage in their business.

03

Emerging Risks

Increasing pressures to incorporate Climate & ESG in the Risk Management processes, Increasing Cyber Risk, and digitalization of Financial Services with new competition.

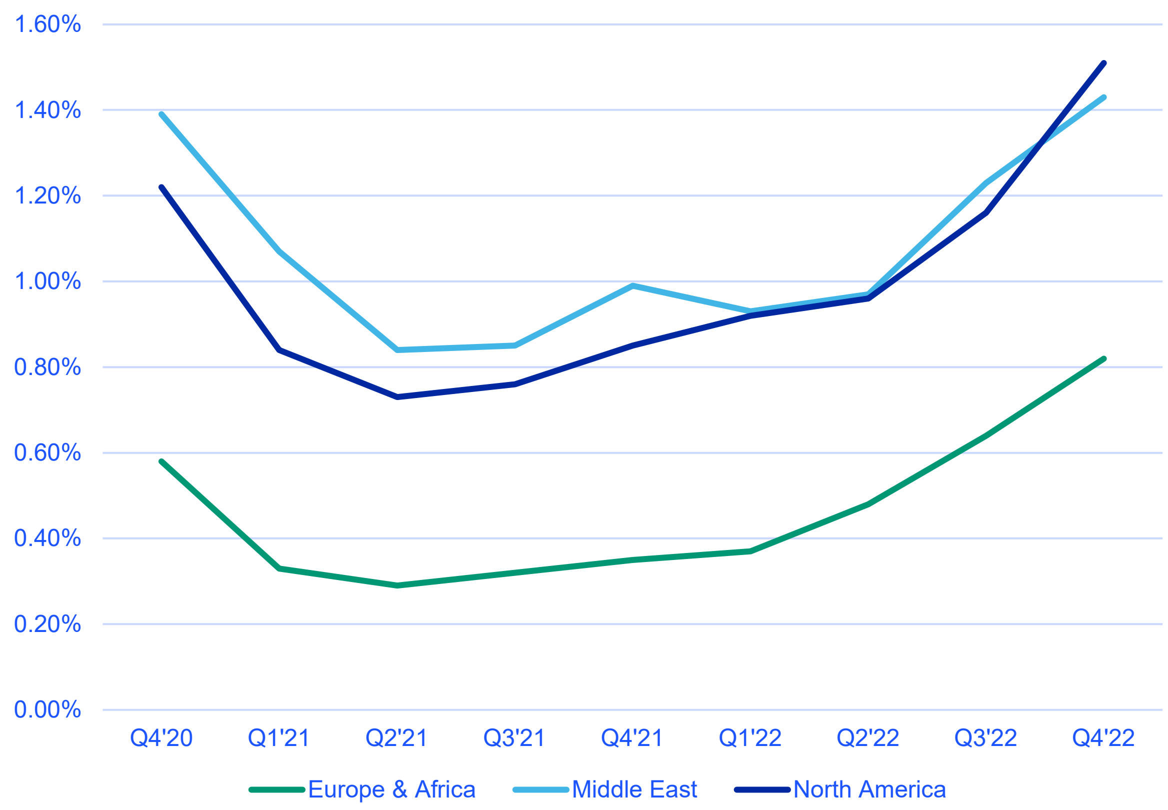
04

1

IFRS 9

ECL volatility

Insides from Moody's Quarterly ifrs9 Benchmark Study



- Benchmark portfolio consist of loans and bonds in three broad regions, IG and HY exposures.
- Moody's Analytics Gcorr Macro and PD Converter models used to calculate unconditional ECL.
- 3 Moody's Analytics scenarios (BL 40%, S1 30%, S3 30%) used for conditional ECL.
- Benchmark study provides a reference point on ECL movements quarter on quarter.

ECL (lifetime)	Q4'20	Q1'21	Q2'21	Q3'21	Q4'21	Q1'22	Q2'22	Q3'22	Q4'22
Europe & Africa	0.58%	0.33%	0.29%	0.32%	0.35%	0.37%	0.48%	0.64%	0.82%
Europe delta		43%	14%	10%	10%	6%	30%	30%	28%

Impact on the Origination Process

Example of how IFRS9 impacts each step

Origination

- KYC, Loan/Insurance underwriting
- Sales/recommendations of financial products
- Credit assessments
- Regulatory mapping
- Treasury loan assessments/funding

Pricing & Portfolio Management

- Portfolio management
- Sentiment/news analysis
- Advisors (Internal & external)
- RAROC
- Funds Transfer Pricing

Core ALM

Planning & Risk MI

- Internal & External Capital
- ALM metrics
- Stress Testing
- Strategy / What-If Analysis
- Forecasting & Budgeting

Accounting

- IFRS9
- Scenario Analysis

Regulatory Reporting

- Financial Reporting (Corep/Finrep)
- Stress Testing
- ICAAP /ILAAP

Balance Sheet Forecasting

Customer → External Reporting

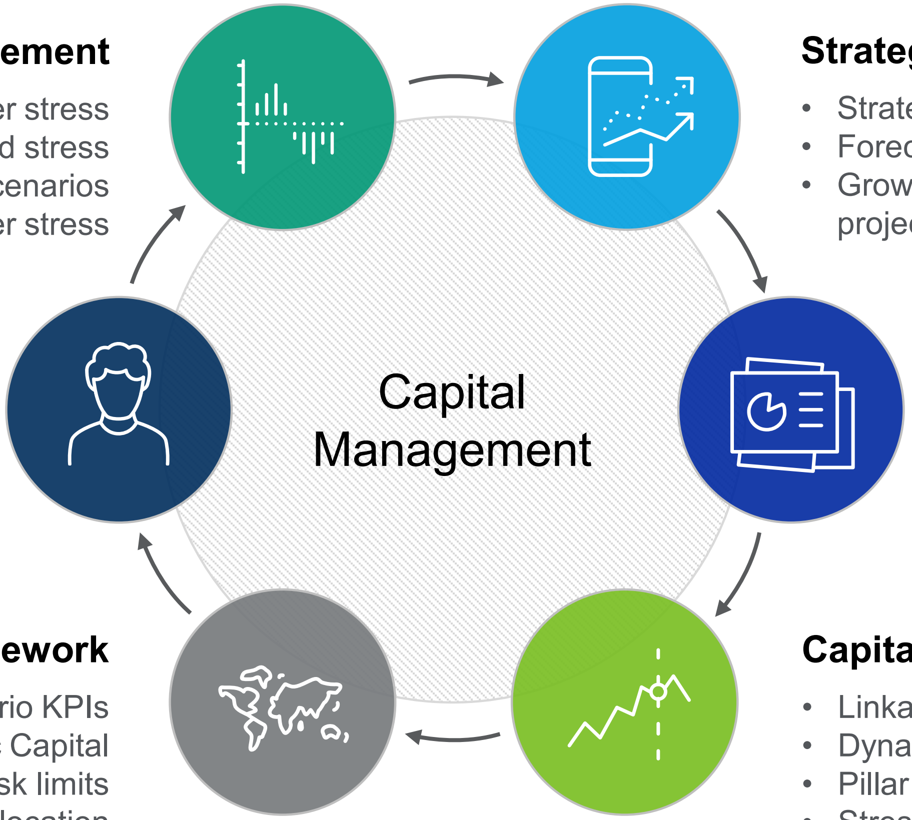
2 Capital Management

Basel IV

Key details

- Reinforcing the standardized approaches for credit risk, credit valuation adjustment (CVA) risk and operational risk, laying out new risk ratings for diverse types of assets, including corporate bonds and real estate.
- Restricting the use of IRB approaches to calculate capital requirements. Basel IV removes the Advanced-IRB (A-IRB) approach option for exposures to large corporate and financial institutions and removes all IRB approach options for equity.
- Introducing a leverage ratio buffer to further limit the leverage of global systemic institutions (G-Sibs) by requiring them to keep additional capital in reserve.
- Removing the advanced measurement approach (AMA) for calculating operational risk and replacing it with a non-modeled standardized approach.
- Replacing the existing Basel II output floor with a more risk-sensitive floor, reducing the low levels of internally modeled RWAs.
- The new rules require banks to hold capital equal to at least 72.5% of the amount indicated by the standardized model, regardless of what their internal model suggests.
- Basel IV will entail a capital allocation distortion and more difficulty in reconciling Pillar 1 and Pillar 2 capital. There is a greater role for Pillar 2 capital to play in this transition towards driving the business while maintaining risk appetite.

Capital Management – Joint goal



Active Portfolio Management

- Portfolio optimization under stress
- RAROC pricing under BL and stress scenarios
- Hedging under stress

Strategic Planning & Forecasting

- Strategy & budget planning
- Forecasting dividend & stock repurchase policies
- Growth strategy, M&As, deleverage projections/strategies under scenarios

IFRS9 Provisions Calculation

- PD & LGD term structure, EAD profile
- Stage allocation
- 12-monht and lifetime ECL calculation

Balance Sheet & Liquidity Management

- Margin and volumes
- NII and funding cost
- LCR/NSFR forecasting
- Liquidity stress testing
- HQLA optimization strategies

Economic capital & Risk Appetite Framework

- Regulatory Capital / Economic Capital & scenario KPIs
- Scenario-consistent Economic Capital
- Setting risk limits
- Capital allocation

Capital Planning, Stress Testing & ICAAP

- Linkage of stress testing to capital planning
- Dynamic balance sheet forecasting
- Pillar I residual risks and Pillar II risks
- Stress testing with IFRS 9 impairments

Linked by consistent models, systems and processes

Impact on Return on Equity

RoE is being ‘squeezed’ from both sides

$$\text{RoE} = \frac{\text{Earnings}}{\text{Capital}}$$

» Optimization strategies need to look at the numerator and denominator.

3 Holistic Risk Capabilities

Challenges

Form the discussed pressures a number of challenges result for banks

Regional differences are materializing, and a one-size-fits-all regulation is becoming less adequate.

Capitalizing on regulatory spent.

Maximize return on regulatory compliance investment: Compliance for the sake of compliance is not sustainable, enabling compliance to interconnect with business performance increases returns for shareholders over time.

Fast decision making based on timely Information.

Improved speed of decision making by organizing and centralizing fragmented data sets for intelligent analysis with a gold standard of data quality. Leverageing the joint power of multiple functions across Bank to create exponential value and insights, linking analysis results.

Consistency and Interconnectedness.

Enabling an efficient and consistent view of risk from front office to back office supports the end goal of maximizing shareholder returns. Accounting for new regulatory shift e.g., Capital Allocation and alignment of Economic (Internal) Capital and Regulatory Capital allocated metric. Inclusion of IFRS 9 Impacts.

Margins are an increasingly important factor in Growth

Volume growth alone is not enough anymore in the current conditions. The focus is shifting to optimizing margins by incorporating outputs from ifrs9 into pricing for example and more efficient capital allocation.

How can these Challenges be addressed

Cornerstones for decision making

- Increased forward looking capabilities (what-if analysis, earnings volatility)
- Consistent scenario library across the planning process
- Incorporate drivers / pressures into EWS, RAROC, Pricing
- Strong Governance across silos and processes
- Introducing a consistent measure of risk across the institution

Enhanced Risk Capabilities

Risk and Finance across silos

Risk Measurement and Provisioning

Scenario driven assessment of default and severity.
Formalization of the idiosyncratic and systemic effects on risk assessment.

Underwriting

Forward looking view of credit.
Enhanced assessment considering obligor / facility characteristics and the macro economic outlook.

Stress Testing and Strategic Planning

Consistency in methodology and scenarios to ensure alignment between BAU risk management and Stress testing.
Ability to quickly assess impact of an evolving world on existing and emerging risks.
Embedding scenario-based analysis and stress testing into firm's strategy and decision making.

Active Portfolio Management

Ability to identify and explain impact of IFRS9 on deal and portfolio risk and earnings.
Understanding of portfolio risk profile and concentrations to detect sources of earnings volatility.
Definition of appropriate actions to improve portfolio's risk and return.

Pricing

Measuring the impact of Expected Credit Loss on Credit Earning.
Consideration of impact of scenarios on credit quality and staging.

Governance

Breaking of business and function silos through rationalization of operations and decision making.
Extended scope of Risk Management's role in managing the firm's financial resources.

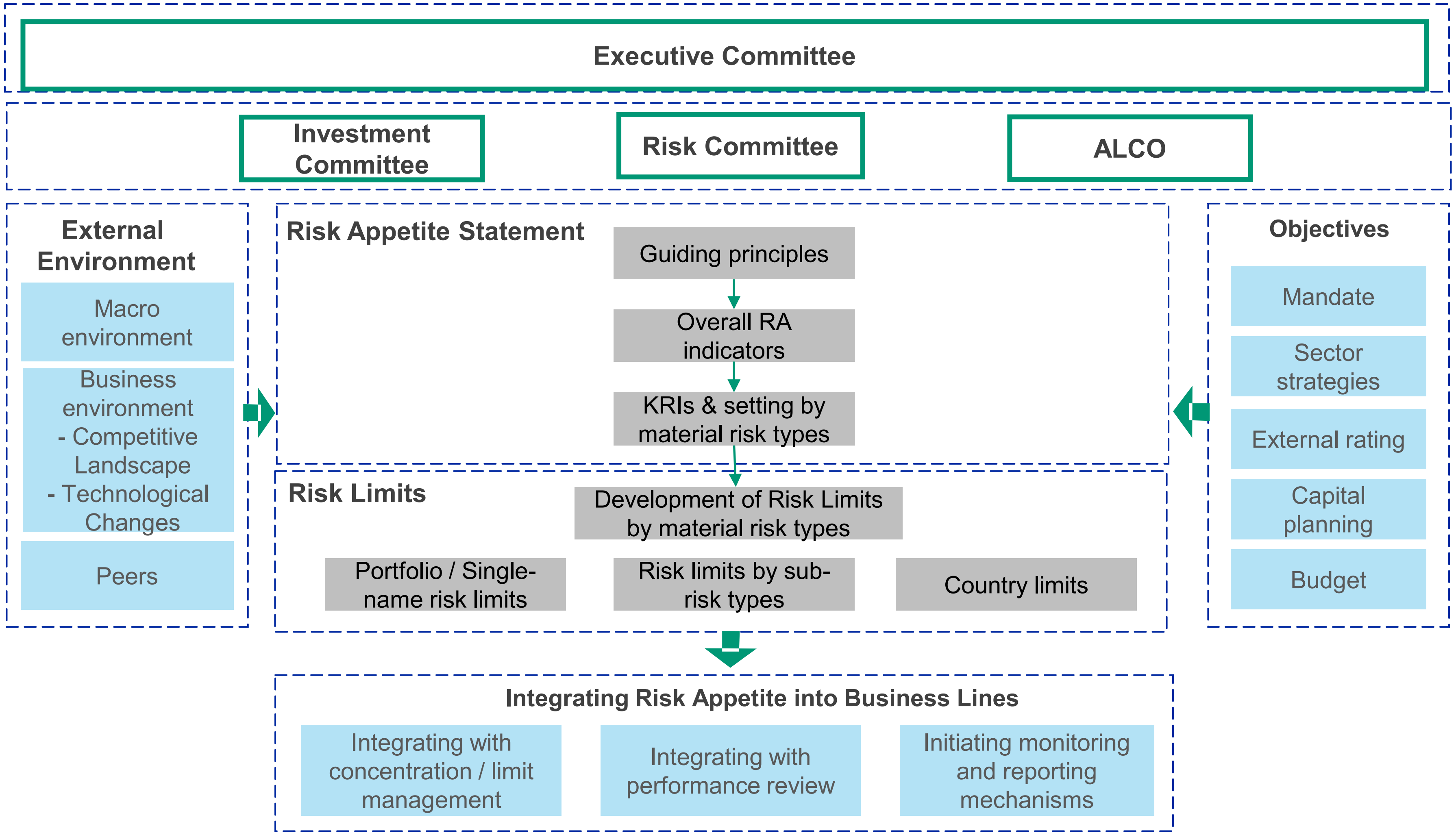
From Silos to Insights

Breaking down silos in pursuit of profitable growth

Sales and Customer Relations	Credit Assessment & Underwriting	Credit Analytics and Benchmarking	Accounting and Finance
Digital Banking	Client Onboarding	Active Portfolio Management	Loss Mitigation and Collections
Capital Markets	Core Banking and Servicing	Treasury	Compliance and Regulatory Relations

Integrate Insights

Governance



- Coordination across finance, treasury and risk
- Embedding within risk & business management through timely and clear communication through chain of command from senior management downwards
- Ongoing education across the organization on assumptions and limitations of methodologies
- Full transparency and auditability of the processes

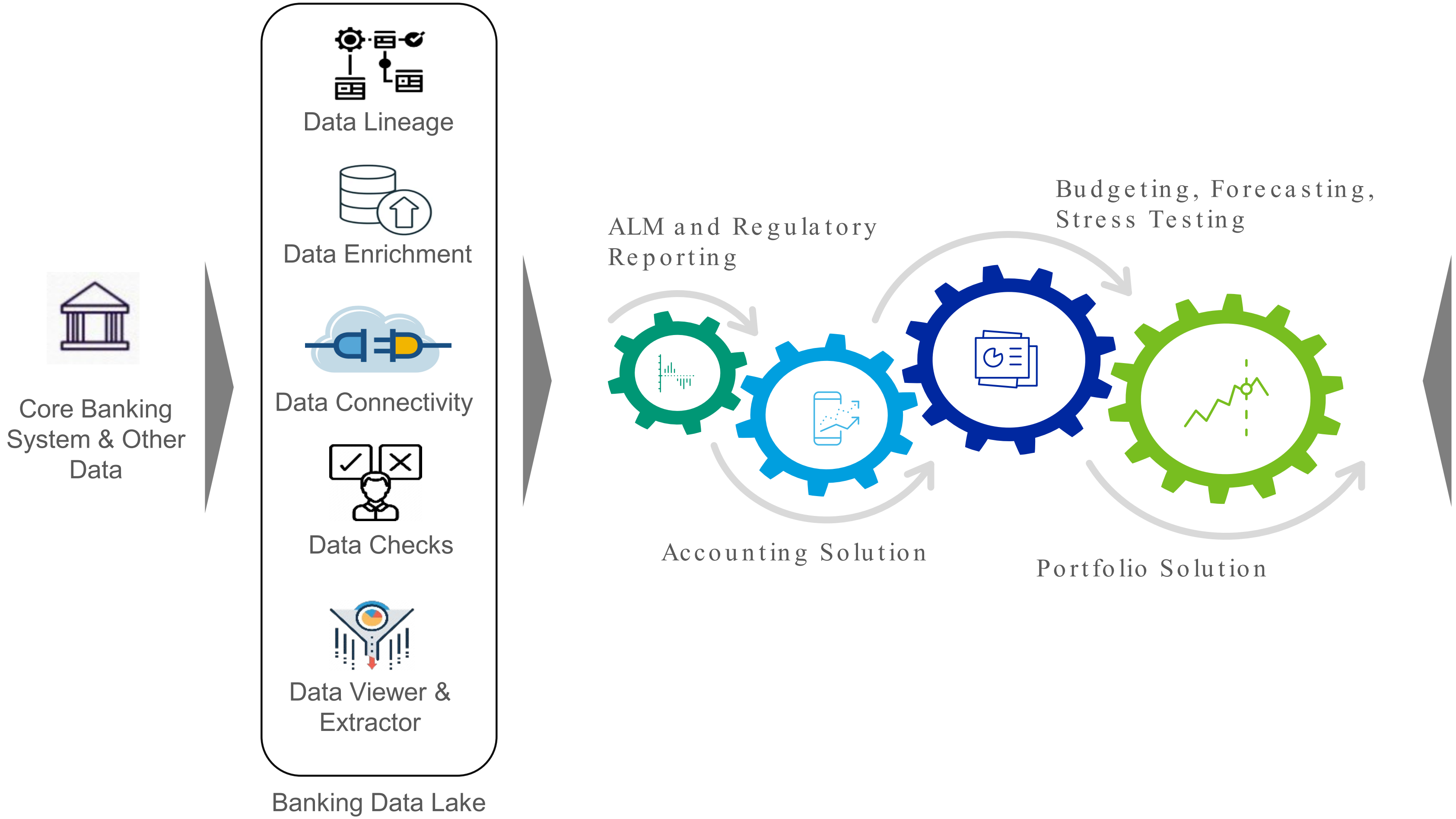
Best Practices

What we see

- Increased focus by Regulators to implement a consistent measure of Risk and increased importance >> Better Decision Making
- Internal consistent measure of Risk ensuring that all stakeholders speak the same language >> Strong Governance
- Technology that supports fast decision making (integrated risk reporting e.g., Impairments, Regulatory Capital, Economic Capital and Stress Testing) >> Connection of the disparate Data and enhance Speed
- Organizational Alignment, Credit Portfolio Management >> Active and Predictive

Solution Approach

From Products to an Interconnected Solution



CONTEXT

During periods of economic slowdown, the credit riskiness of portfolios increases and therefore banks are required to set aside substantial provisions. Capital levels decrease creating capital shortfalls. Negative earnings and volatility increase likelihood of negative capital surplus. Triggered levels of NPLs (Problem loans) consume large amounts of capital as they attract large RWAs.

OBJECTIVES

Unified Capital & Impairments Management:

- Combined regulatory, internal capital analytics with impairments
- Compute & Assess IFRS 9 ECL Volatility impacts on CET1, as well as on Internal Capital and Earnings
- Support capital enhancement and Portfolio Strategies : Capital Raising, Asset Sales/Acquisitions, Securitization (STR/STS)

ENABLERS

- Common data dictionary across Regulatory, Internal Capital and Impairments
- Expanded Reporting encompassing Core Tier 1 and Tier 2 impacts, as well as buffers.
- What-if Scenario Analysis: Forecasted RWAs, Reg buffers, Internal capital under macro (climate for Pillar 2) forecasts
- What-if analysis module for incremental analysis (vs existing portfolio/segment) incl. variables such as output floor, as well as LCR/NSFR ratio

THANK YOU

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