Credit Risk Coverage Benchmarking as a Risk management Tool

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ALVAREZ & MARSAL

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Executive Summary

METHODOLOGY -

- A&M has carried out a detailed analysis gathering all relevant **NPL coverage data** to assess **disparities among European countries and Banks**.
- Benchmarking includes country, bank and **asset class level** (mortgages, consumer, corporates, SMEs, and specialized lending) as far as public information is available using all available sources.

COVERAGE DISPARITIES – Country View

- Remarkable **volatility around coverage ratios** among European countries have ranged from 60% to 30% within the 2^{nd} and 3^{rd} quartiles. This divergence has persisted over the past **3 years.**
- The **gap closes up** significantly when **collaterals** are taken into account. A similar trend is observed across distinct asset classes. **LGDs** are notably reduced when **collateral** levels rise.
- Provisioning and Collateral level disparity is not dependent on Asset Mix, thus generating potential problems with regulators and investors.

WHY IS THIS ANALYSIS USEFUL? -

1. This analysis can be used to deal with **regulatory and investor inquiries**.
2. **Using Benchmarking also is relevant to detect if an institution is an outlier or if high or low levels can be explained by certain asset classes.**
3. A&M's approach provides also clearer picture to **assess coverage across peers and facilitate internal management discussion upon underwriting and refinancing.**
4. **For management purposes it can provide a tool to measure a banks relative position and steer.**

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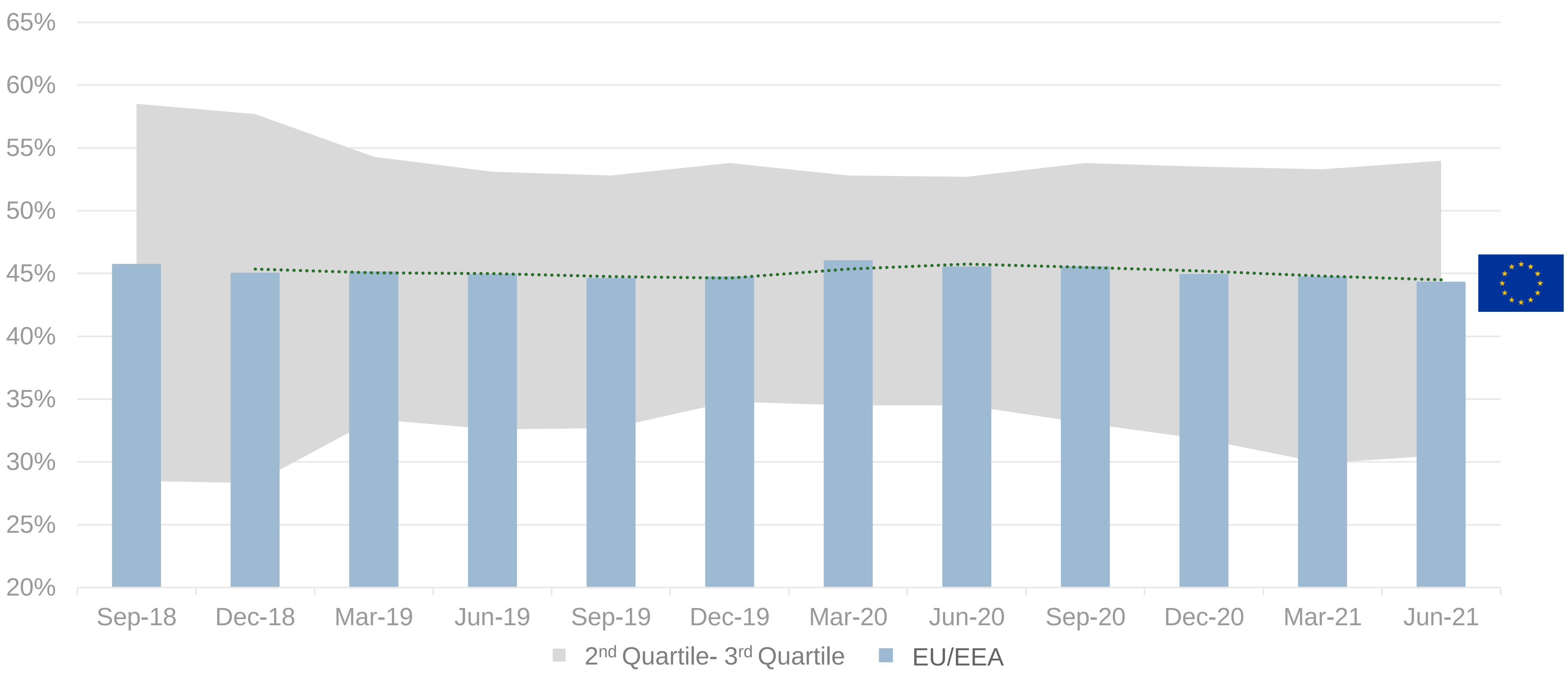
Country Benchmarking Analysis – NPL coverage ratios trends

NPL Coverage Ratio in the EU has remained steady over time but the significant disparities among countries is also quite large. Moreover, volatility around coverage ratios among European countries has ranged from 60% to 30% within the 2nd and 3rd quartiles.

Coverage Ratio of NPL Trends (2018-2021)



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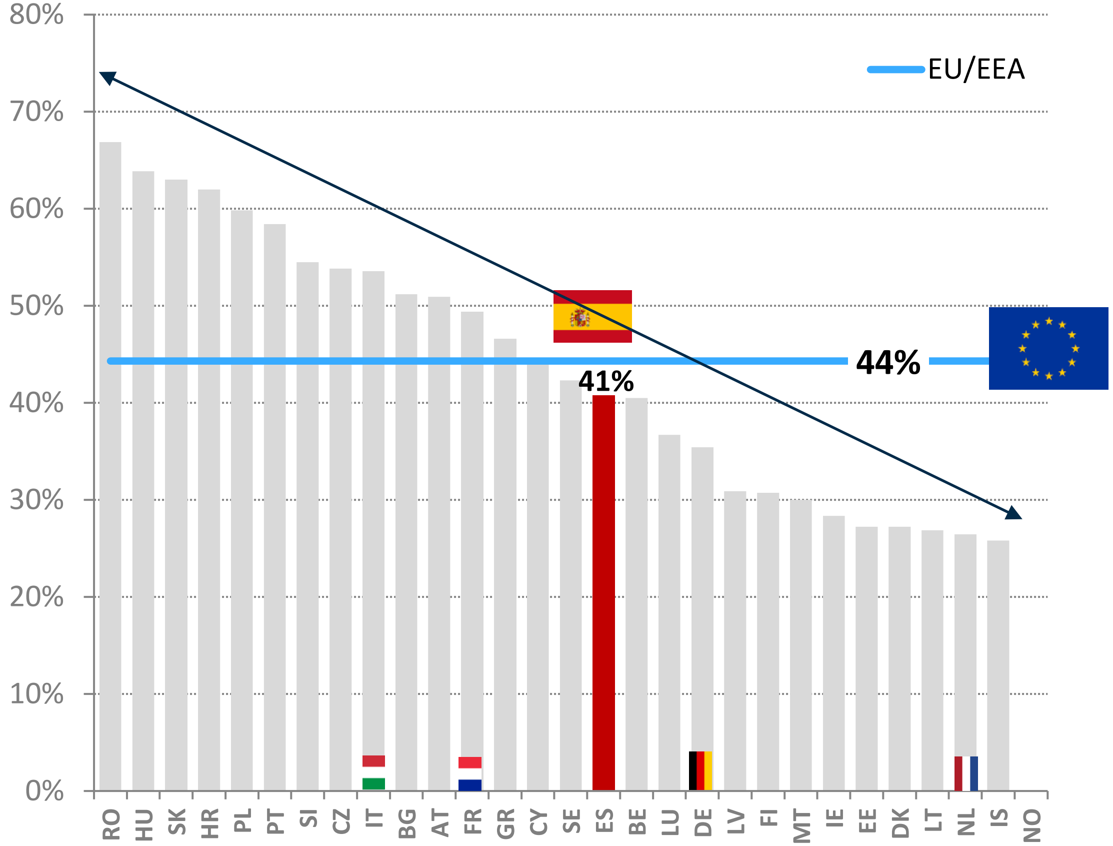
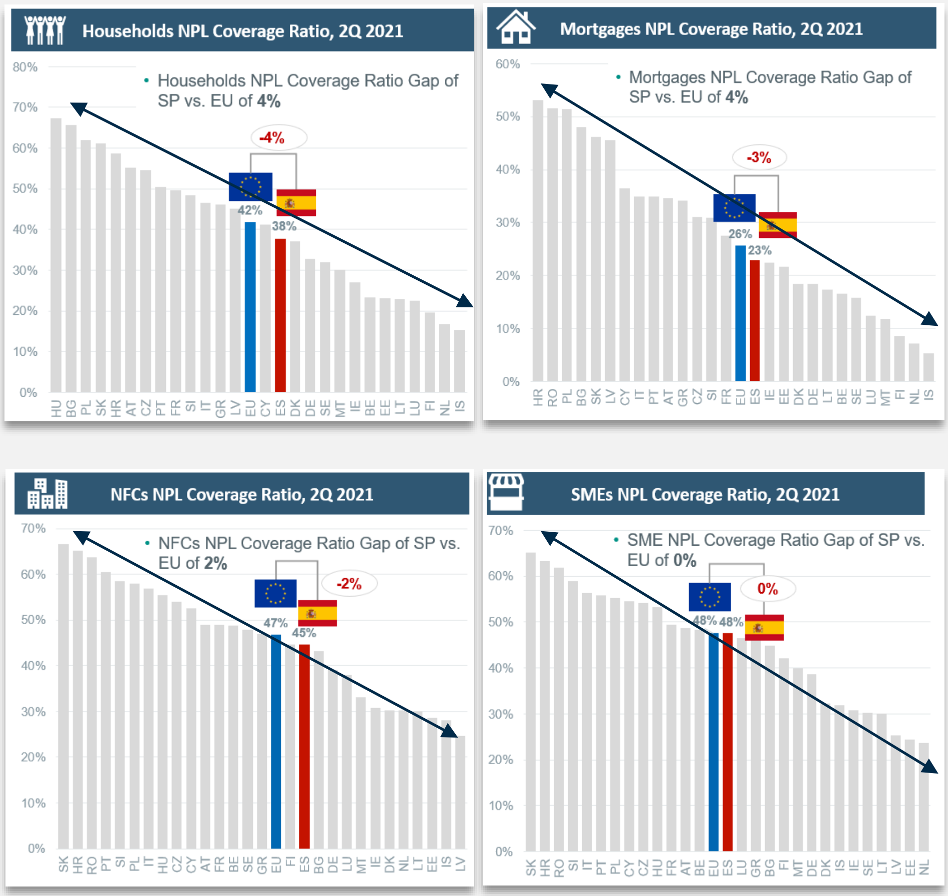
Country Benchmarking Analysis – NPL coverage ratios

NPL Coverage Ratio in Spain around the EU average but large gaps are observed among the “average” and large Peers like Netherlands and Nordics with <30% and Southern Countries like Italy c.55% and Portugal c.60%. Same trend is seen across all asset classes.



Business NPL Coverage Ratio by Asset Class



Source: EBA Risk Dashboard. Weighted Averages by country

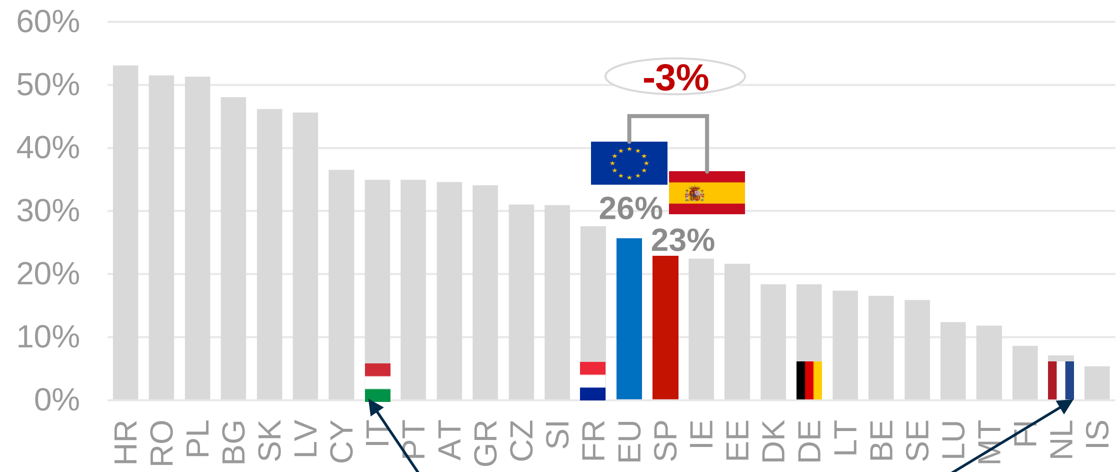
Country Benchmarking Analysis –

Zoom NPL coverage ratios by Asset Class with collateral

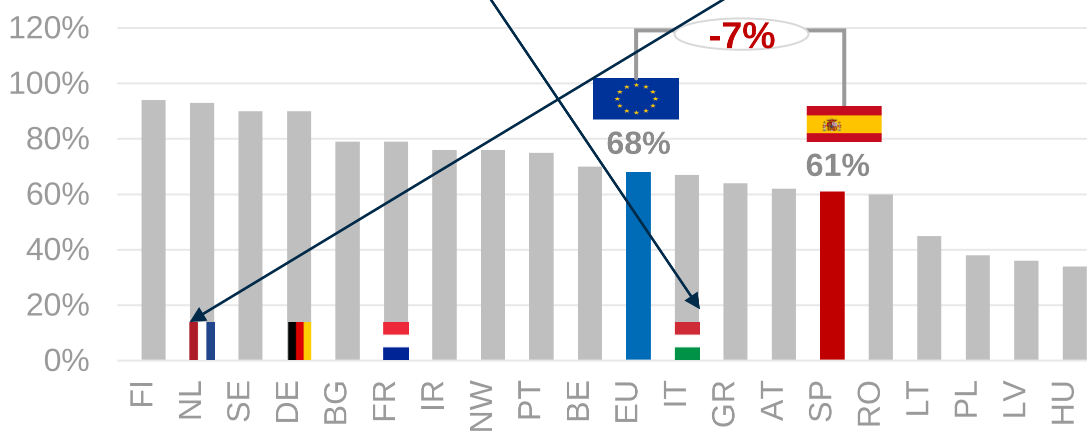
2018	2019	2020	2021

2018	2019	2020	2021

Mortgages NPL Coverage Ratio

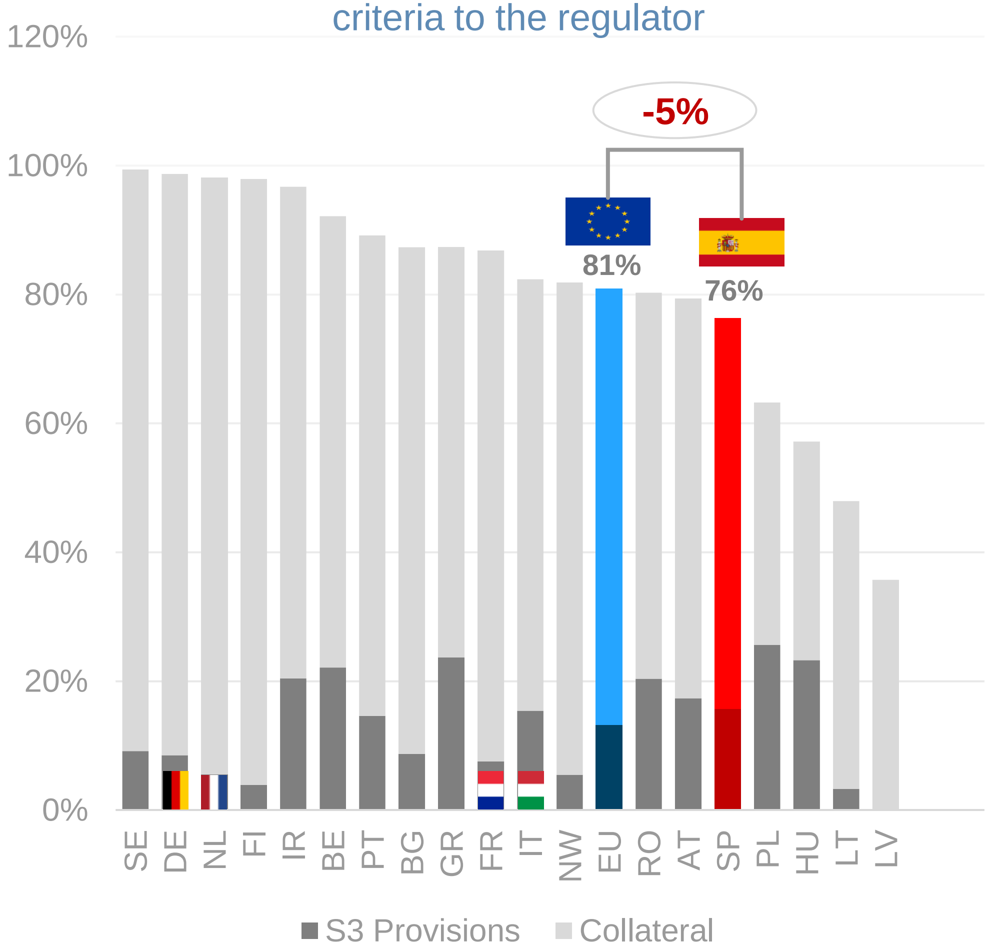


Mortgages Collateral Ratio



Mortgages NPL & Collateral Coverage Ratio

Adding up collateral levels reduce the gap but can generate concerns on underwriting and refinancing criteria to the regulator

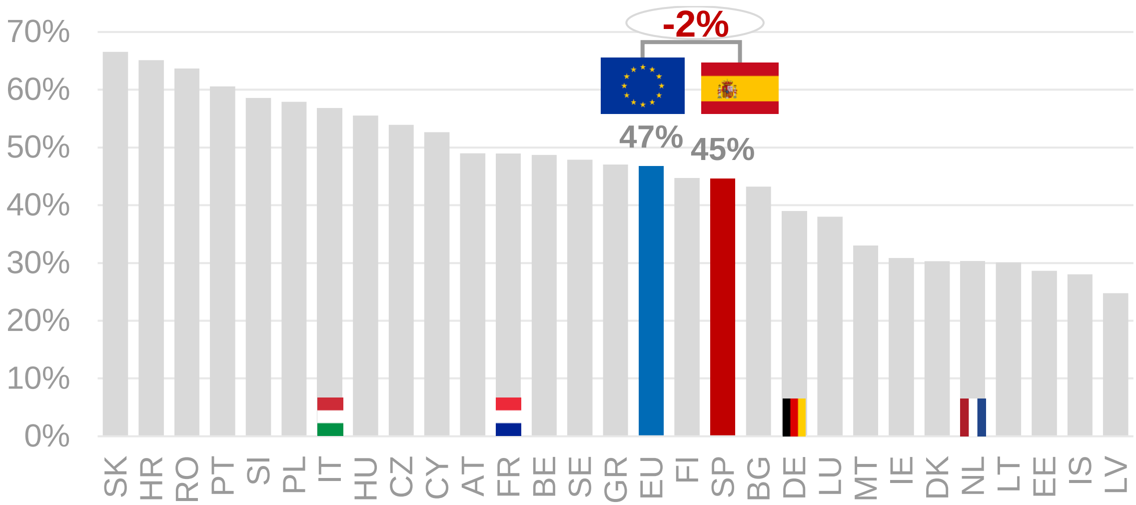


Source: EBA Risk Dashboard. Weighted Averages by country

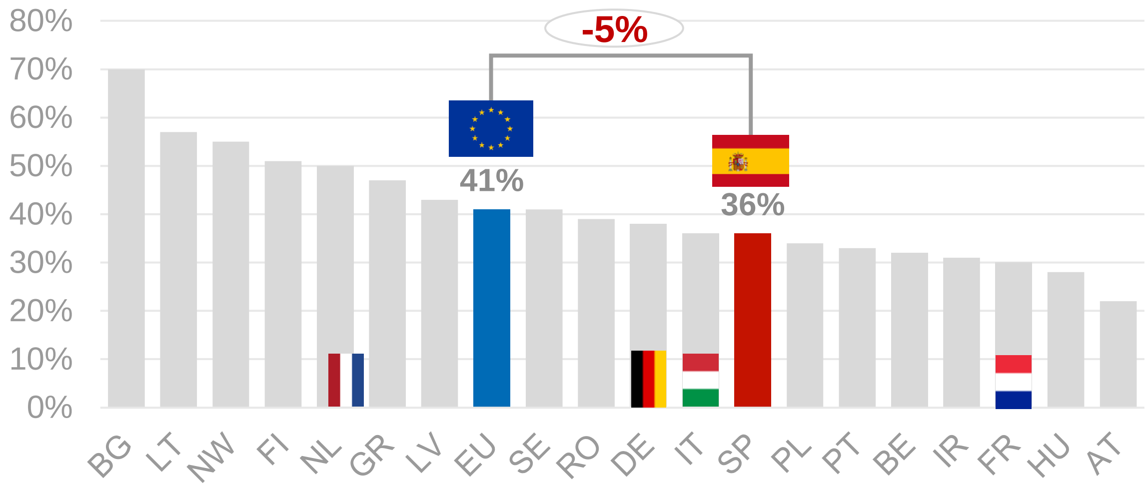
Country Benchmarking Analysis – Zoom NPL coverage ratios by Asset Class

2018	2019	2020	2021

NFCs NPL Coverage Ratio



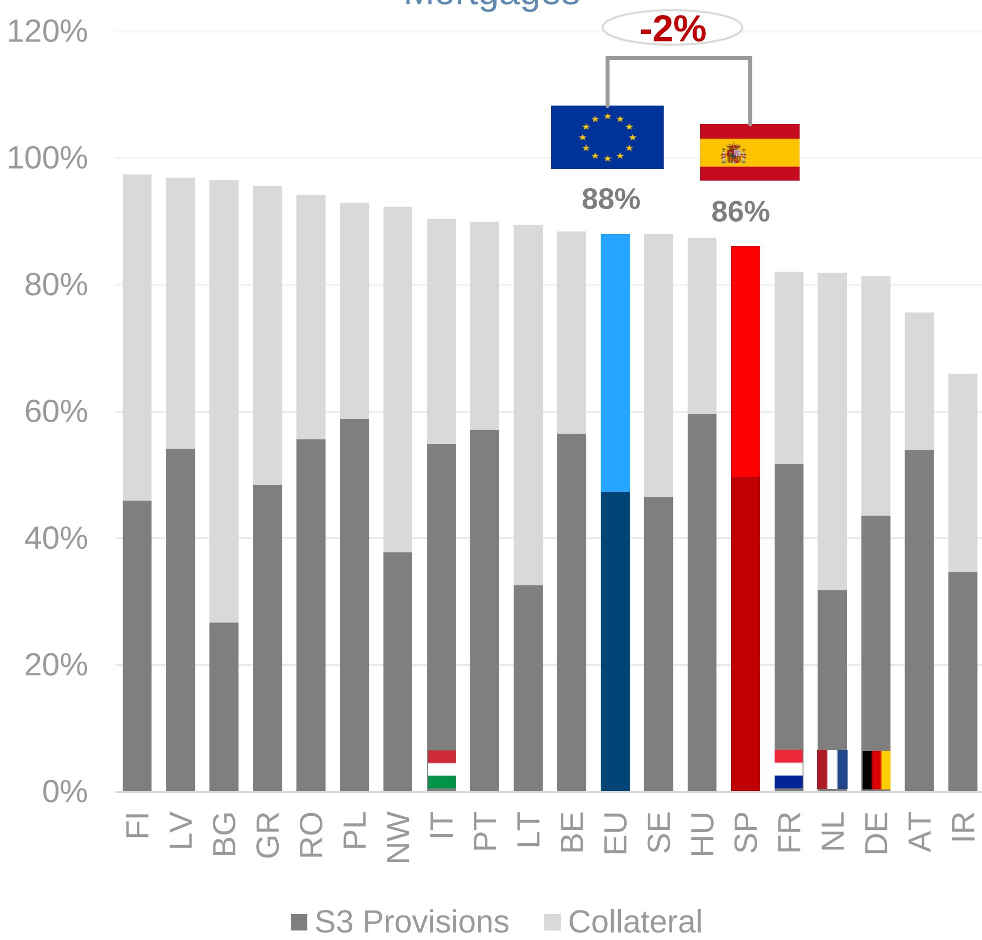
NFCs NPL Collateral Ratio



2018	2019	2020	2021

NFCs NPL & Collateral Coverage Ratio

The same trend can be seen in Asset Class not directly linked to Real Estate Financing like Mortgages



Source: EBA Risk Dashboard. Weighted Averages by country

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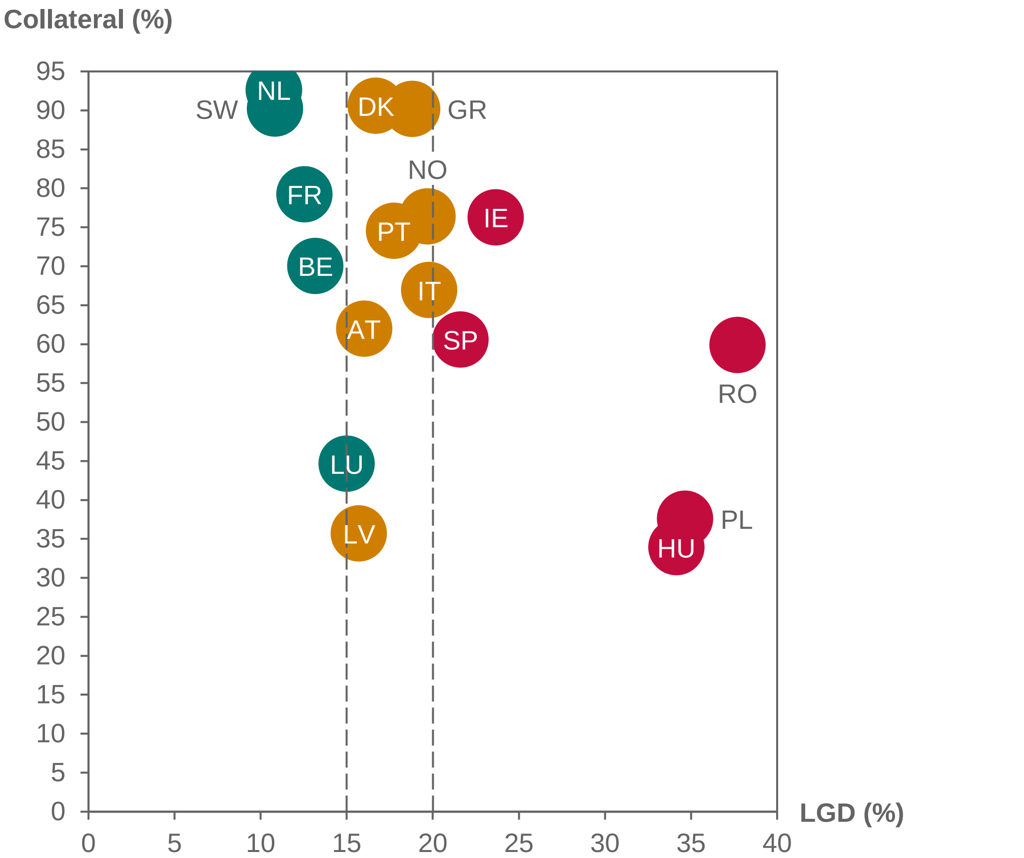
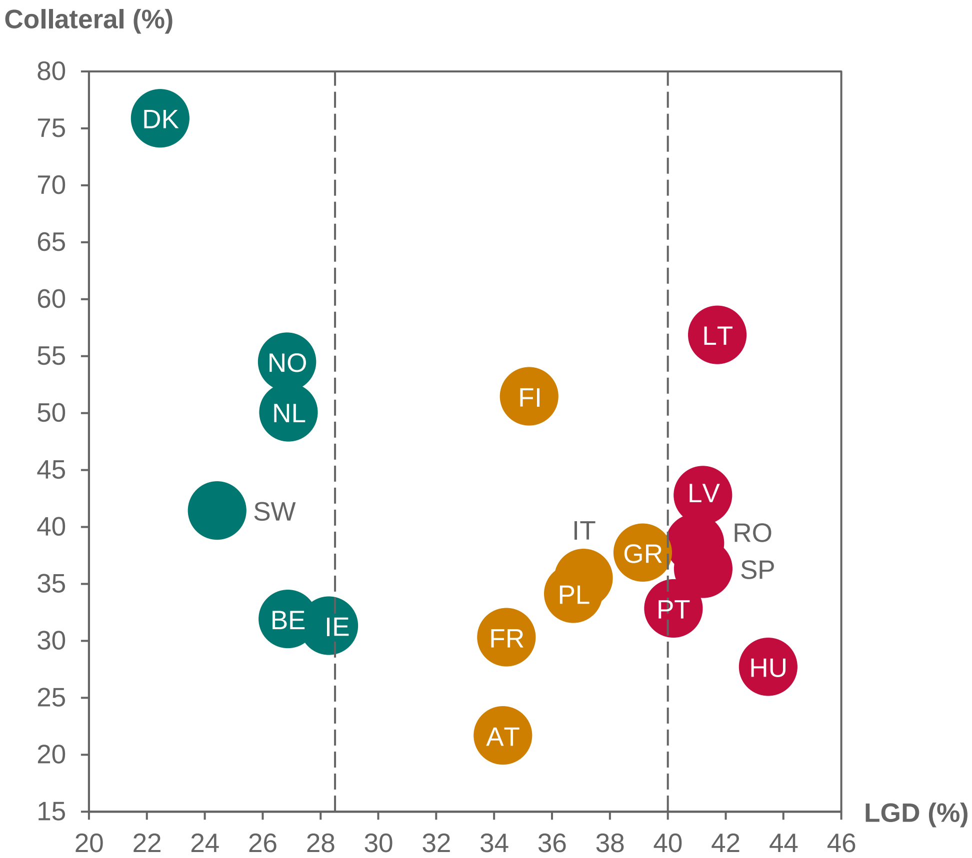
Country Benchmarking Analysis
– LGD & Collateral correlation by Asset Class

LGD tends are lower in countries with higher collateral coverage ratio, green bubbles represent those countries with favorable scenarios. Low LGDs lead to lower expected losses and, therefore, fewer provisions are required.

Mortgages LGD & Collateral Coverage Ratio



NFCs LGD & Collateral Coverage Ratio



Source: EBA Risk Dashboard. Weighted Averages by country

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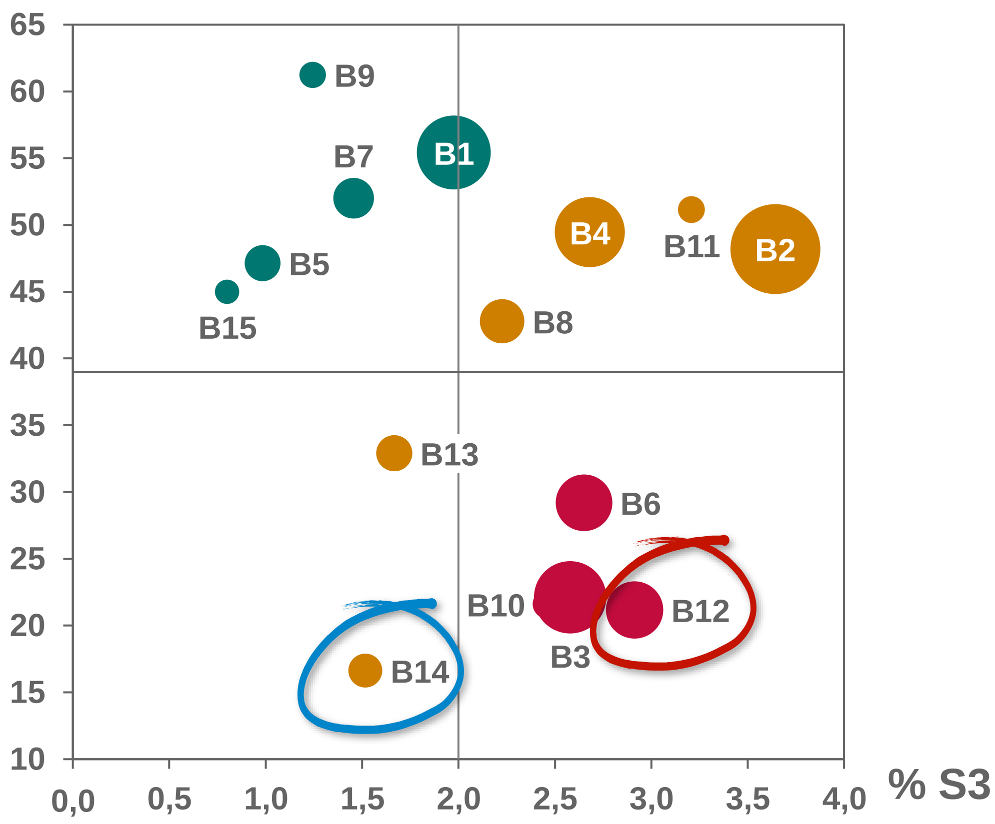
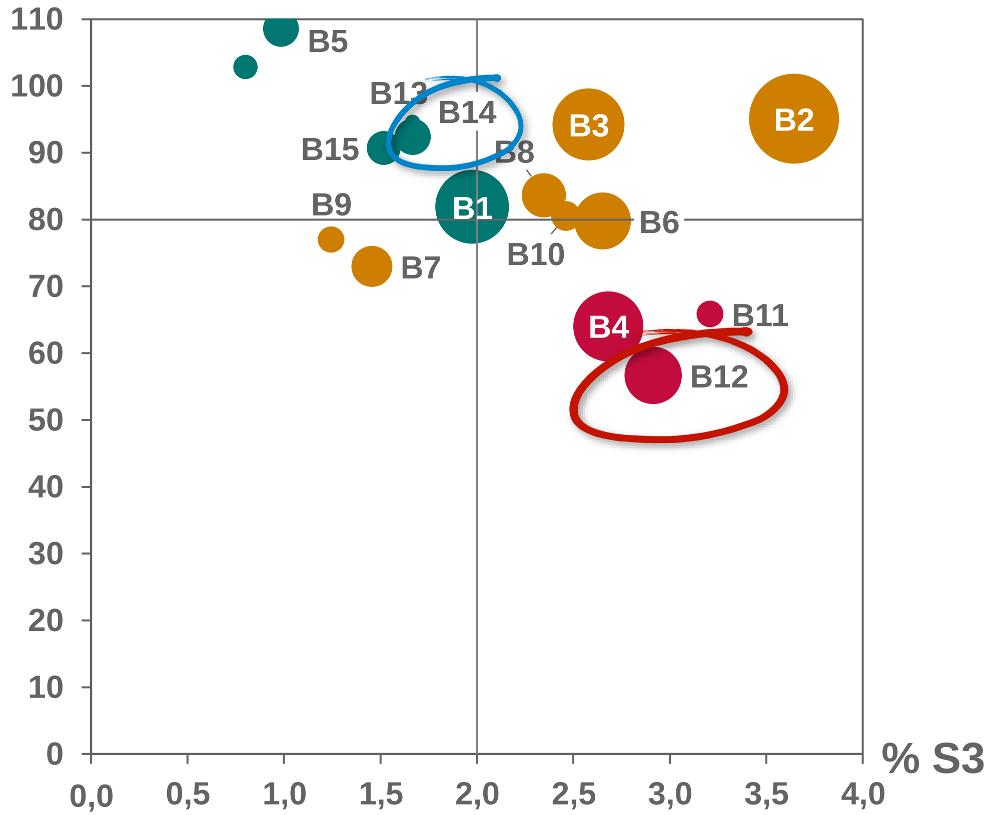
Peer View – NPL coverage ratios

The Analysis can be used not only at a country level, but at a Peer Level Group to detect if a Bank is an outlier or to help defend a lower provisioning level than Peers vs the Regulator or Investors

Low %S3 & High Coverage | High %S3 & High Coverage | Low %S3 & Low Coverage | High %S3 & Low Coverage

Total





Source: EBA EU-wide stress test + S&P Global Market Intelligence

(*) Outliers have been removed.

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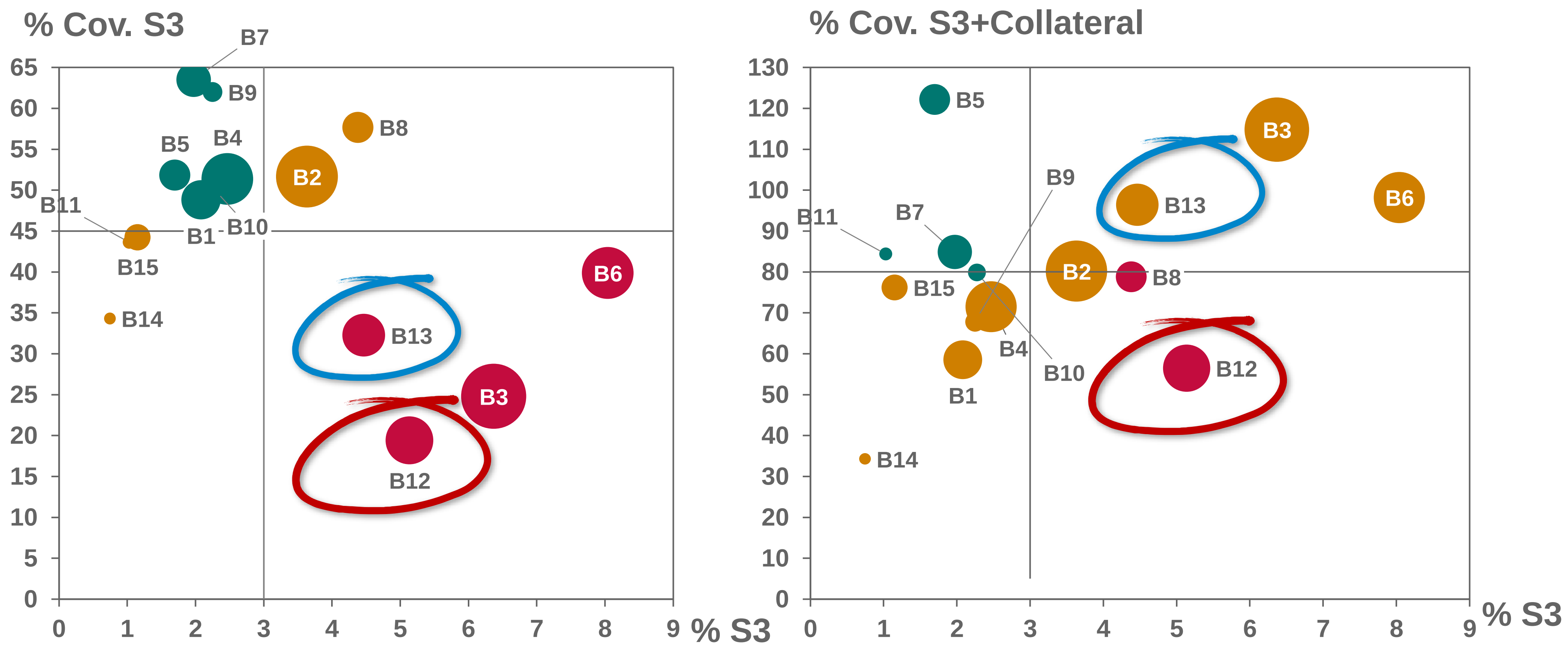
Peer View – NPL coverage (NFC)

Drilling down to Peers and Asset Classes detects Portfolios that might need review not only for S3 but for anticipation

Bubble size – S3 Exposure (in €)

Low %S3 & High Coverage | High %S3 & High Coverage | Low %S3 & Low Coverage | High %S3 & Low Coverage

Total



Source: EBA EU-wide stress test + S&P Global Market Intelligence

(*) Outliers have been removed.

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Glossary & Sources

	Metric	Description	Sources
Coverage	S1, S2, S3 Coverage Ratio	Stage *x* Provisions / Stage *x* Exposure	EBA EU-wide stress test + S&P Global Market Intelligence / Pillar III
Collateral	S3 Collateral	Stage 3 Provisions + Collateral / Stage 3 Exposure	EBA Transparency Exercise / Pillar III
Stages and Coverage By Asset Class	1) Households - Secured by Real Estate 2) Households – Other 3) NFC – Corporates 4) NFC – SMEs 5) NFC – Specialized Lending	1) Mortgages to retail clients 2) Credit to consumers for personal use 3) Loans to large corporations 4) Loans to Small and Medium Enterprises 5) Exposure to finance physical assets	EBA EU-wide stress test + S&P Global Market Intelligence / Pillar III
KPIs	Coverage by stage and Asset Class	Coverage by Stage & Asset Class & Collateral (if available)	EBA EU-wide stress test + EBA Transparency Exercise
	Texas Ratio with Collateral	CET1 / (Stage 3 Exposure – provisions – collateral)	EBA EU-wide stress test + S&P Global Market Intelligence
	Cost of Risk	P&L Cost of Risk / Exposure (bps)	S&P Global Market Intelligence
	RWA: Risk Parameters	PD / Loss Rates	EBA Risk Parameters from EBA Risk Dashboard

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