Adjustment to risk methodology for calculating contributions to the deposit guarantee scheme

March 2017

The Dutch Deposit Guarantee Scheme (DGS) is financed by banks through the assessment of risk based contributions. The risk methodology for the DGS uses multiple indicators to classify banks into four risk categories. In early 2017, this methodology has been slightly adjusted. The new risk methodology will be used as of the second quarter of 2017. This fact sheet provides an overview of the adjustments.

1

What is the purpose of the risk methodology?

Since 2016, banks pay a quarterly contribution to the Dutch deposit guarantee fund. In 2024, the fund has to achieve a target level of 0.8 percent of the deposits covered by the DGS. For the banking sector as a whole, about half of the quarterly contribution is determined through a basic contribution, which is solely based on the size of the covered deposits of each bank. The other half of the quarterly contribution is determined through a risk contribution which is assigned to banks on the basis of a risk-weighted measure of the covered deposits of each bank.

DNB determines the risk classification of each bank using a risk methodology that is laid down in national legislation.[1]

The risk methodology consists of five risk dimensions that provide insight into the solidity of a bank[2]:

i. Capital position;
ii. Liquidity and funding;
iii. Asset quality;
iv. Business model and management;
v. Potential losses for the DGS.

Each risk category contains one or two indicators. Specific weights are attached to each indicator. Using the weighted values on risk indicators, banks are assigned into one of the four risk categories. Depending on the category to which a bank is assigned, covered deposits will be weighted by a factor of 50, 100, 150 or 200 percent.

2

Why has the risk methodology been adjusted?

Early 2017, the risk methodology has been adjusted on two fronts. The adjustments affect the indicators for the risk dimension liquidity and funding and potential losses for the DGS.

Within the risk dimension liquidity and funding, the original indicator (liquid assets / total assets) has been replaced due to the termination of the national liquidity reporting on which this indicator was based. From now on, the risk dimension liquidity and funding will be measured using two indicators that are based on the liquidity coverage ratio (LCR). The new indicators are liquidity buffer / total assets and liquidity buffer / covered deposits. Together, these indicators reflect the extent to which the exposure of the DGS on a bank is covered by liquid assets. The performance of these two indicators together – with a combined total weight of 12.5 percent in the risk methodology – is to a high degree comparable with the liquidity indicator that was used previously.

1 The principles of the risk methodology are laid down in articles 29.10 – 29.20 and annex B and C of the *Besluit bijzondere prudentiële maatregelen, beleggerscompensatie en depositogarantie Wft.* Detailed specifications of the risk methodology are laid down in the *Regeling risicoindicatoren bijdragen depositogarantiestelsel Wft.*

2 These five risk dimensions originate from the guidelines developed by the European Banking Authority on methods for calculating contributions to deposit guarantee schemes (EBA/GL/2015/10).

Within the risk dimension potential losses for the DGS, the original indicator (covered deposits / total assets) will be complemented with an indicator measuring the encumbrance of assets (encumbered assets / total assets). When the original risk methodology was determined in 2015, the requirement to report the level of asset encumbrance existed only briefly. This implied that there was too little experience with the reported data to determine the quality and consistency of the data. In the meantime, it has become clear that the reported data on asset encumbrance is of sufficient quality to warrant an inclusion of this indicator to enrich the measurement of the risk dimension potential losses for the DGS. The level of asset encumbrance provides insight into the extent unencumbered assets are available for recovery during an insolvency procedure. The smaller the amount of encumbered assets, the greater the potential recovery on the estate of the failed entity. This is also beneficial for the potential recovery rate on the super preferred claim that the DGS will have in case of insolvency.

The total weight that is assigned to the risk dimension potential losses for the DGS remains 12.5 percent. Within the risk dimension, both indicators have received a weight of 6.25 percent.

3

Under the new risk methodology, what determines the risk classification of a bank?

The new risk methodology consists of seven indicators for the five risk dimensions. The weight of all indicators adds up to 100 percent. Each indicator has a lower boundary and upper boundary, which determine the boundaries for the score on each indicator. For each indicator, the performance of banks is normalized to a value between 0 and 1. This makes the performance on all indicators comparable, in order to measure the overall riskiness of a bank.

Table 1 Specification of new risk methodology

Risk dimension	Risk indicators	Weight	Lower Boundary*	Upper Boudary*
Asset quality	Risk exposure / TA	50%	0%	100%
Capital position	Leverage Ratio	12,5%	6%	3%
Liquidity and funding	Liquidity buffer / TA	6,25%	100%	0%
	Liquidity buffer / Deposits covered by the Dutch DGS	6,25%	100%	0%
Business model and management	Return on assets	12,5%	0,2%	0%
Potential losses for the DGS	Deposits covered by the Dutch DGS / TA	6,25%	0%	100%
	Encumbered assets / TA	6,25%	10%	30%

* Indicators are normalized between these boundaries. The lower boundary is equal to 0 (low risk), the upper boundary is equal to 1 (high risk). Within these boundaries, the indicator score is calculated using a sliding scale approach. .

The new indicator for the level of asset encumbrance (encumbered assets / total assets) can serve as an example. The lower boundary for this indicator is 10 percent and the upper boundary is 30 percent. A bank with 260 encumbered assets and 1.000 total assets has a level of asset encumbrance equal to 26 percent. Based upon the lower- and upper boundaries, this therefore leads to an indicator score of 0.8.

Note that for a few indicators the normalization occurs in the reverse direction (a high value on the risk indicator equals a low indicator score). This is the case for those indicators where a high value equals low risk, the leverage ratio being a case in point. Table 1 provides the specifications of the new risk methodology.

The indicators are based on variables which banks periodically have to report as part of FINREP and OREP. The annex provides an overview of the cells used in the risk methodology and the specific position where they can be found within the reporting frameworks. The calculation of indicator scores is based on the reported values at the assessment date, which equals the end of the quarter preceding the quarter over which the contribution is payable. Hence, the assessment date for the 2nd quarter of 2017 is 31 March 2017 (see table 2).

Table 2 Quarters and assessment dates

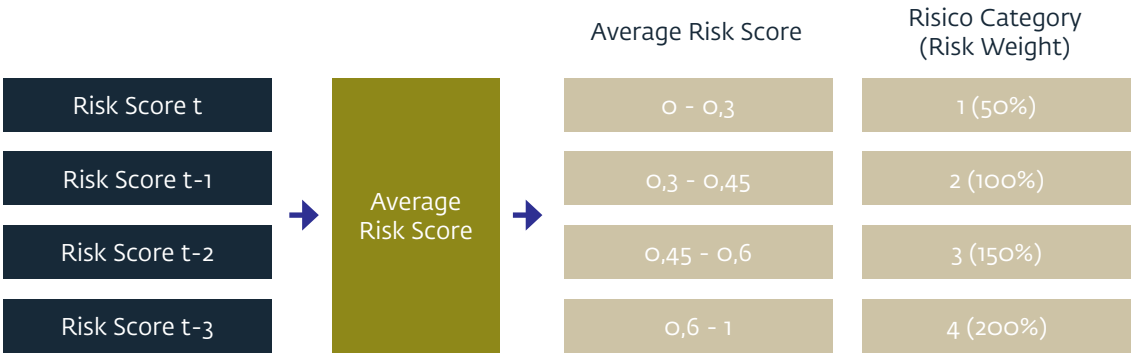
Quarter over which the contribution is payable	Assessment date
1st quarter	31 December
2nd quarter	31 March
3rd quarter	30 June
4th quarter	30 September

After determining indicator scores, the risk score of a bank equals the weighted average of the indicators scores all indicators scores. In the example mentioned above, an indicator score of 0.8 on asset encumbrance – with a weight of 6.25 percent – would increase the risk score of the bank with 0.05 (0.8 x 6.25 percent).

To avoid (seasonal) spikes in the calculated values, the classification of a bank is based on the average risk score over the last four quarters. Because it was possible to calibrate the new risk methodology in such a way that the outcomes of the methodology are comparable to the previous methodology, the border values between the four risk categories have remained the same. Where the average risk score of a bank is smaller than 0.3, the bank will be classified in risk category 1 which leads to a risk weight of 50 percent. The border between risk category 2 (100 percent) and risk category 3 (150 percent) is set at an average risk score of 0.45. Banks with an average risk score equal to or greater than 0.6 will be categorized into risk category 4 (200 percent). Figure 1 visualizes the process of risk classification.

Figure 1 Calculation of risk category using the risk scores

t = quarter over which the contribution is payable



4

When will the adjusted risk methodology be used for the first time and what future adjustments can be expected?

The new risk methodology was published in the Staatscourant (Government Gazette)[3] on the 15th of March 2017. The new methodology will be used as of the second quarter of 2017, for which 31 March 2017 is the assessment date, to classify banks into risk categories. Because the classification occurs using the average risk score over the last four quarters, the calculation of risk based contributions over the second quarter of 2017 will still be based on the risk score that followed from the previous methodology for three of the four quarters that are used in the calculation. In subsequent quarters, the use of the previous methodology will be gradually phased out further. The calculation over the first quarter of 2018 is the first that will be fully based on the new risk methodology.

The next review and recalibration of the risk methodology will be more comprehensive and is scheduled for late 2018 with the aim to adopt a revised methodology in early 2019. At that time, there will be more experience with the risk methodology

3 See 'Regeling van de Minister van Financien van 7 maart 2017, 2017-0000044353, directie Financiele Markten, tot wijziging van de Regeling risico-indicatoren bijdragen depositogarantiestelsel Wft in verband met aanpassing van risicoindicatoren voor de dimensies potentiele verliezen voor het depositogarantiestelsel en liquiditeits- en financieringsprofiel' (only available in Dutch).

and the review can reflect on conclusions drawn by the EBA in its review of the guidelines on methods for calculating contributions to DGS that has to be finished in 2017. DNB will involve the banking sector once it starts this next evaluation of the risk methodology.

In case you have any questions on the adjustment of the risk methodology for the DGS, please contact the DGS info desk (dgs@dnb.nl).

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Annex: Data used by risk methodology

The variables used to compose the risk indicators originate from data that needs to be periodically reported (COREP and FINREP) by banks in line with the Commission Implementing Regulation on Supervisory Reporting. Table 3 provides detailed reference to the fields used as input for the risk methodology. In addition to the variables that are based upon COREP- and FINREP, the risk methodology also uses the variable deposits covered by the Dutch DGS. The values for this variable are based on the reporting requirements on the deposit base of the bank, as meant by article 130, paragraph 1, sub d, of the decree on prudential rules under the Wft.

Table 3 Overview of fields used as input for the risk methodology

Variable	Annex*	Template number	Template code	Row	Column
Leverage ratio	X	47	C47.00	330	010
Liquidity buffer	XXIV	76	C76.00	010	010
Total assets	III	1.1	F01.01	380	010
Risk exposure	II	2	C02.00	010	010
Net income**	III	2	F02.00	670	010
Encumbered assets	XVI	32.1	F32.01	010	010

* Annex to the Commission Implementing Regulation on Supervisory Reporting (nr. 680/2014)

** Regarding the net income on a quarterly basis, it is noted that banks have to report each quarter their cumulative net income over the financial year. In order to come to not the cumulative, but the actual net income over a specific quarter, an adjustment of the reported data is necessary in case of the second, third or fourth quarter of a financial year. The adjustment consists of a subtraction of the reported net income over the previous quarter(s) within the same financial year from the reported net income over the applicable quarter.