

## PRUDENTIAL CAPITAL ASSESSMENT REVIEW

The Central Bank and Financial Regulator has carried out an exercise to determine the forward-looking prudential capital requirements of certain of the Irish credit institutions covered by the government guarantee. The Prudential Capital Assessment Review (PCAR) process for Allied Irish Bank, Bank of Ireland and EBS has been concluded and the results are set out below, together with the status of Anglo Irish Bank, Irish Nationwide Building Society and Irish Life and Permanent.

The Prudential Capital Assessment Review (PCAR) assesses the capital requirements arising for expected base and potential stressed loan losses, and other financial developments, over a 3 year (2010-2012) time horizon. It involves the Central Bank and Financial Regulator making an assessment of the recapitalization requirements of the credit institutions in order to satisfy both a base case and stressed target capital requirement.

The PCAR has been undertaken to determine the recapitalisation requirements of the credit institutions with reference to both:

- A target level of 8% core tier 1 capital should be attained after taking account of the realisation of future expected losses and other financial developments under a base case scenario. This test is designed to ensure the credit institutions are capitalised to a level which reflects prudential requirements and current market expectations, after taking account of forecast loan losses through to 2012. As a further prudent requirement, the capital used to meet the base case target must be principally in the form of equity, the highest quality form of capital, with 7% equity as the target level. In calculating the requirements, individually specified amounts have been added to the institutions' estimates of expected losses to take account of the uncertainty of loss forecasts for particular portfolios.
- A target level of 4% core tier 1 capital that should be maintained to meet a stress scenario or a portfolio level sensitivity analysis. This capital test, which is similar to that employed by US and UK supervisory authorities, is designed to ensure the credit institutions have a sufficient capital buffer to withstand losses under an adverse scenario significantly worse than currently anticipated.

**The Financial Regulator has required the credit institutions that have completed the exercise to prepare recapitalisation plans to comply with the additional capital specified by the PCAR. The level of additional capital required for each institution under the PCAR analysis is set out below. This amount of capital set by the PCAR process must be in place by the end of 2010.**

Recapitalisation to the target requirements specified in the PCAR will provide market participants with the confidence that the institutions have a strong capital base after realising forecasted expected losses and that a prudent capital buffer is in place to withstand additional losses in adverse stress conditions.

## PCAR Methodology

The PCAR has involved the Central Bank and Financial Regulator making an assessment of the recapitalisation requirements of the credit institutions involved in the exercise in order to satisfy both a base case and stressed target capital requirement.

A team of prudential supervisors, credit specialists and treasury specialists in the Financial Regulator, supported by Central Bank economists and financial stability specialists, conducted the PCAR by:

- Assessing the provisioning estimates of each credit institution, their Basel capital model outputs, expected loss forecasts, funding costs and projected operating income;
- Reviewing independent third party estimates of provisions and expected losses conducted on specific credit institutions' portfolios;
- Reviewing likely and stressed scenario loan loss projections for portfolio categories by credit rating agencies and other sources including regulatory agencies;
- Reviewing the outcome of modelled base and stress macro-economic scenarios that we specified and mandated the credit institutions to calculate;
- Using information received from NAMA in respect of the first tranche of "haircuts" as the basis for estimating the NAMA loan losses<sup>1</sup>;
- Applying prudent buffers to estimates of expected loan losses;
- Applying prudent adjustments to base case and stress scenario funding costs and treasury asset losses;
- Applying knowledge of the quality of loan portfolios gained through our more intensive supervisory interaction with the banks, including observation of Credit Committee deliberations; and
- Benchmarking our analysis to the approaches taken by other leading international financial supervisors.

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<sup>1</sup> Credit institutions may apply to the Financial Regulator by 30 June 2010 for a downwards revision to their capital requirements, if the haircuts on subsequent tranches are materially lower than the first tranche or the quantum of loans to be transferred is lower.

The PCAR methodology assessed the capital requirements arising for expected base and potential stressed losses, and other financial developments, over a 3 year (2010-2012) time horizon.

The PCAR required the assessment to take account of changes to EU prudential banking capital requirements that have been formally adopted, even if they have yet to be implemented. This does not include the “Basel II plus” changes that are still at consultation stage, although the potential changes were noted as part of our overall assessment of target capital levels.

### **Stress Test**

In this test the capital requirement of 4% core tier 1 capital is designed to ensure that banks will be adequately capitalised even after experiencing a hypothetical adverse macroeconomic scenario or unexpected severe losses on particular loan portfolios. This capital level is equivalent to that established by the UK Financial Services Authority<sup>2</sup> and similar to that established by the US Federal Reserve, Federal Deposit Insurance Corporation and Office of the Comptroller of the Currency<sup>3</sup>.

The stress test requirement is based on a severe scenario of hypothetical adverse macroeconomic conditions and therefore involves an element of judgment. The stress test inputs **do not represent a forecast** of likely economic developments by the Central Bank and Financial Regulator, instead they are much more adverse than what is considered likely.

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<sup>2</sup> FSA Statement on its use of stress tests, 28 May 2009

<sup>3</sup> Joint Statement by US Authorities on the Treasury Capital Assistance Program and Supervisory Capital Assessment Program, 6 May 2009. The Committee of European Banking Supervisors has also conducted bank stress testing exercises but has not set a common buffer stress capital requirement, leaving this to national discretion. The result of the adverse scenario was that on aggregate Tier 1 would remain above 8% and no single bank would fall below 6% Tier 1.

The Central Bank and Financial Regulator required firms to stress test their portfolios to the higher of:

- The firms estimated loan losses in a stress scenario based on a delayed macroeconomic recovery scenario prescribed by the Central Bank and Financial regulator<sup>4</sup> and,
- Application of severe sensitivity shocks to the loan book at a portfolio specific level. This included loan loss rates of 5% for mortgages in Ireland and non-NAMA developments property loan losses of 60% in Ireland and 35% in the UK. We emphasise that these are not forecast or expected loss levels, and are disclosed to show the extent of the stress that has been applied in the test. These loss rates are not based on any macroeconomic scenario and therefore should not be interpreted in that manner.

It is the losses established under the portfolio level sensitivity approach that have provided the binding stress case capital requirements, rather than the macroeconomic scenario.

The use of stress testing to benchmark prudential capital requirements will become a part of the regulatory framework operated by the Central Bank and Financial Regulator.

### **Recapitalisation Plans**

The Financial Regulator has required the credit institutions to prepare recapitalisation plans in light of the PCAR results. The credit institutions are required to set out their plans to ensure that capital is in place by the end of 2010 to a level calculated by reference to the base capital target, after taking account of projected expected losses, including bank-specific and other adjustments. We will permit credit institutions to take account of projected asset disposals, based on valuations confirmed by independent third parties, where these are well progressed at year end.

The credit institutions are also required to set out their plans to ensure that capital is in place by the end of 2010 to a level calculated with reference to the stress capital target, taking account of stressed losses and other adjustments. We are currently assessing various approaches to meeting the stress capital target and in principle we will permit credit institutions to take account of contingent capital facilities which trigger at a level of 5% core tier 1.

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<sup>4</sup> As the starting point for determining the stress capital requirement, the banks were provided with a specified macroeconomic scenario based on a hypothetical delayed economic recovery, involving negligible GDP growth in 2011 and 2012, persistent unemployment increasing to 14.7% in 2012, a further cumulative house price decline of 24.8% in the years 2010-2012 beyond the 31.5% decline reported and other parameters. The severity of the stress test takes account of the circumstances of the Irish economy and its position in the economic cycle.

## **PCAR Results by Bank**

*The capital requirements resulting from the PCAR exercise are:*

### ***Allied Irish Banks plc (“AIB”):***

- (1) An additional €7.396 bn of equity capital to meet the base case target of 7% equity, before taking account of projected asset disposals, and
- (2) €4.865 bn of Core Tier 1 capital, less any equity generated under paragraph 1 excluding conversion of preference shares held by the Government, to meet the base case target of 8% Core Tier 1. This additional Core Tier 1 capital will also satisfy AIB’s stress case target of 4% Core Tier 1.

### ***The Governor & Company of the Bank of Ireland (“BOI”):***

- (1) An additional €2.66bn of equity capital to meet the base case target of 7% equity, and,
- (2) In meeting this requirement provided at least €0.25 bn of new Core Tier 1 is raised, then Bank of Ireland also meets (a) the base case target of 8% Core Tier 1, and, (b) the stress target of 4% Core Tier 1.

### ***EBS Building Society (“EBS”):***

- (1) An additional €875m of Core Tier 1 capital to meet the base case target of 8% Core Tier 1, and,
- (2) Contingent capital of €120m of Core Tier 1 capital to meet the stress case target of 4% Core Tier.

*Other Institutions for which the PCAR has not been completed:*

### ***Anglo Irish Bank Limited (“Anglo”):***

The PCAR for Anglo has not yet been undertaken because discussions on its restructuring plan between the bank, Government and the European Commission are still at a formative stage. If the bank’s preferred option – which is to carve out a much smaller but viable going concern banking entity with the remainder becoming an asset management entity – is approved by the European Commission, the PCAR will be applied to the balance sheet of the new banking entity.

As an interim measure, Anglo Irish Bank will require an additional €8.3 billion of capital to meet current minimum capital requirements, pending conclusion of the restructuring discussions and the application of the PCAR.

### ***Irish Nationwide Building Society (“INBS”):***

The Financial Regulator has estimated the capital shortfall to meet current minimum capital requirements for INBS at €2.6 billion. In line with all credit institutions, INBS must comply with this minimum regulatory capital requirement on an ongoing basis.

### ***Irish Life & Permanent plc (“ILP”):***

ILP was not included in the first wave of PCAR as it has not received a government capital injection and is not taking part in NAMA.

The PCAR process for ILP will be completed over the coming months as the institution’s restructuring plan is developed.

**Appendix:**

**The PCAR Map**

**Base Capital Calculation**

**Start** with Current Capital of bank and forecast Operating Results

*Deduct* impairments on NAMA loans

*Deduct* impairments on non -NAMA loans until 2012

**Make Adjustments** on bank specific basis:

*Add/Deduct:* changes to NAMA volumes and % haircut

*Deduct:* regulatory adjustment for loan loss uncertainty

*Deduct:* adjustment for funding cost risk

*Deduct:* Other amendments to forecast operating results

*Amend:* Risk Weighted Assets to reflect impact of impairment and other changes

**Determine Capital Shortfall** for base case ratios based on adjustments

*Add:* Capital injection by 31 December 2010

**Result: Target Base Capital of 8% Core Tier 1 of which 7% Equity**

## **The PCAR Map**

### **Stress Capital Calculation**

**Start** with Current Capital of bank and forecast Operating Results

*Deduct* impairments on NAMA loans

*Deduct* impairments on non NAMA loans until 2012

**Make Adjustments** on bank specific basis:

*Deduct:* changes to NAMA volumes and % haircut

*Deduct:* hypothetical stress losses through to 2012 derived from the higher of:

(a) the prescribed macroeconomic scenario

(b) the prescribed portfolio level sensitivity loss rates

*Deduct:* regulatory adjustment for funding cost risk under stress scenario

*Deduct:* Other amendments to forecast operating results (*same as base*)

*Add:* capital injection by 31 December 2010-03-25 or Contingent Capital Facility

*Amend:* Risk Weighted Assets to reflect impact of impairment and other changes

**Determine Capital Shortfall** for base case ratios based on adjustments

*Add:* Capital injection by 31 December 2010

**Result:**      **Target Stress Capital of 4% Core Tier 1**