

# REPORT ON CONVERGENCE OF SUPERVISORY PRACTICES

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**EBA**

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# Abbreviations

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AIRB	Advanced Internal Rating Based	HDP	high default portfolio
APR	all price risk	ICAAP	Internal Capital Adequacy Assessment Process
BCBS	Basel Committee on Banking Supervision	ICT	information and communication technologies
BMA	business model analysis	ILAAP	Internal Liquidity Adequacy Assessment Process
BoS	EBA Board of Supervisors Directive 2014/59/EU (Bank Recovery and Resolution Directive)	IMV	initial market valuation
BRRD		IQD	interquartile dispersion
CCB	capital conservation buffer	IRB	Internal Ratings Based approach
CCF	credit conversion factor	IRC	incremental risk charge
CCP	central counterparty	IRRBB	interest rate risk in the banking book
CCR	counterparty credit risk		implementing technical standard
CET1	Common Equity Tier 1	ITS	
COREP	Common Reporting Framework Directive 2013/36/EU (Capital Requirements Directive)	LGD	loss given default
CRD	Regulation (EU) No 2013/575 (Capital Requirements Regulation)	M&A	mergers and acquisitions
CRR		MRWA	market risk-weighted assets
CVA	credit valuation adjustment	NPL	non-performing loan
EAD	exposure at default	O-SII	other systemically important institution
EBA	European Banking Authority	OCR	overall capital requirements
EEA	European Economic Area	P2G	Pillar 2 Guidance
EIOPA	European Insurance and Occupational Pensions Authority	P2R	Pillar 2 Requirements
ELBE	best estimate of expected loss	PD	probability of default
ESE	European Supervisor Education Initiative	Q&A	questions and answers
ESMA	European Securities and Markets Authority	RTS	Regulatory Technical Standards
FINREP	financial supervisory reporting	RW	risk weight
FinTech	financial innovation and technology	RWAs	risk-weighted assets
FIRB	Foundation Internal Rating Based	SCOP	Standing Committee for Oversight and Practices
FX	foreign exchange	SEE	South-Eastern European
G-SII	global systemically important institution	SME	small and medium-sized enterprises
GC	global charge	SRB	Single Resolution Board
		SREP	supervisory review and evaluation process
		SSM	Single Supervisory Mechanism
		sVaR	stressed value at risk
		TSCR	total SREP capital requirements
		VaR	value at risk

## Executive summary

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This report provides a summary of the 2016-2017 EBA assessment of convergence of supervisory practices in accordance with Article 107 of the CRD. This is the third annual supervisory convergence report. It tracks progress made by competent authorities since the 2016 assessment, considering ongoing policy development work and reflecting previous observations and recommendations made by EBA staff to competent authorities.

In 2017, the EBA has continued to enhance its convergence monitoring and assessment toolkit by further expanding bilateral convergence visits – the tool first introduced in 2016. These visits allow constructive dialogue on the practical implementation of the EBA regulatory products and provide feedback to the EBA policy development process. They are highly beneficial for EBA staff and attract positive feedback from the competent authorities.

### *The EBA notes progress in achieving convergence, but challenges remain*

The EBA notes a good degree of progress that has been made by competent authorities in the implementation of the SREP Guidelines as well as in taking forward recommendations and observations made by the EBA during the 2016 bilateral convergence visits. The EBA expects further significant progress in supervisory convergence following the implementation of the revisions and clarifications to the SREP framework currently being introduced, in accordance with the EBA Pillar 2 Roadmap, where some elements (e.g. P2G) have been already rolled out by competent authorities. Further supervisory convergence will be achieved through the revision of the elements of the Pillar 2 framework in the CRR/CRD, which despite the positive end impact may also have a negative near-term impact, as, because the discussion is ongoing, competent authorities are waiting for the final results of the political negotiations before adjusting their methodologies/practices.

Challenges remain, however, primarily in the areas of methodologies for the capital adequacy assessments and determining institution-specific additional own funds requirements. This is most clearly illustrated by the different approaches to using ICAAP, the disparity between risk taxonomies, differences in the transparency of setting P2R, where it is not based on the risk-by-risk determination, and the use of P2R for macroprudential purposes. In turn this leads to differences in the articulation and communication of P2R to supervised institutions.

Focusing on the actual measure imposed, despite the outstanding methodological differences, compared with 2016 the EBA noticed improvements and increasing consistency in actual P2R imposed by competent authorities based on SREP outcomes, resulting in the narrowing of the ranges of P2R across the authorities.

Limited experience of P2G and the current lack of a common framework make the analysis of the first wave of using P2G difficult. Nonetheless, the majority of the competent authorities are setting P2G, albeit with divergences in approach, and convergence should increase as the authorities start implementing the common framework for setting P2G that is introduced in the revised SREP Guidelines.

Continuous improvement in the functioning of college of supervisors is illustrated in this report, which demonstrates the progress that has been made over time and the important link between colleges of supervisors of cross border banking groups and supervisory convergence across the Single Market.

*Major revamp of supervisory policy products also considering outcomes of the past assessments*

Many of the aspects identified in the 2016 convergence assessment are reflected in the EBA's current policy work on Pillar 2 and incorporated into the Pillar 2 Roadmap<sup>1</sup>. In particular, 2017 will see an update of the SREP Guidelines (e.g. using supervisory stress testing in capital adequacy assessment and introduction of P2G, clarification of the role of viability scores, etc.) that will be finalised in 2018 and will apply from 1 January 2019.

The EBA is actively engaged in providing a solid basis for further strengthening convergence of supervisory practices by updating a wide range of its regulatory products addressed to competent authorities and covering various supervisory assessments ranging from internal governance to internal models. These updates reflect the ongoing supervisory developments, as well as the changes in the international fora (BCBS).

*Expansion in training activities continues*

The EBA is also stepping up its activities in training of supervisors by further expanding its residential offering and investing in online training facilities that would ensure that the line supervisors in the competent authorities have a greater reach.

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<sup>1</sup> <https://www.eba.europa.eu/documents/10180/1814098/EBA+Pillar+2+roadmap.pdf>

## Background and introduction

1. The main tasks of the EBA include contributing to the establishment of high-quality common regulatory and supervisory standards and practices, contributing to a common supervisory culture, and conducting peer-review analyses of the competent authorities in order to strengthen consistency in supervisory outcomes. The supervisory convergence mandate of the EBA is built around the following main areas:
  - common supervisory culture and European Supervisory Handbook;
  - convergence of the SREP and consistency of supervisory measures;
  - convergence and consistency in colleges of supervisors;
  - peer-review analyses of competent authorities.
2. The mandate related to the convergence of the SREP is included not only in the EBA's founding regulation, but also specifically in Article 107 of the CRD, which also extends the scope of supervisory convergence to supervisory measures. According to these mandates, the EBA shall promote convergence of the SREP and supervisory measures in order to introduce strong supervisory standards in the EU, assess methodologies used by the competent authorities, assess the functioning of the SREP, report to the European Parliament and Council of the EU on the degree of convergence, and issue guidelines for competent authorities.
3. This report has been prepared in accordance with this mandate. It covers the main activities undertaken by the EBA to enhance supervisory convergence within the scope of Article 107 of the CRD, as well as noting the remaining challenges and the way forward. This is the third convergence report that the EBA has prepared based on this mandate<sup>2</sup>, and to this end the assessment and findings are presented here considering the observations made in the previous reports.
4. The EBA defines convergence as 'a process for achieving comparable supervisory practices in Member States which are based on compliance with the EU rules and which leads to consistent supervisory outcomes.' Under this definition, there are three components of supervisory convergence (see Figure 1).

Figure 1. Components of supervisory convergence



<sup>2</sup> All previous EBA convergence reports can be found here: <http://www.eba.europa.eu/supervisory-convergence>

5. Compliance with technical standards, guidelines and recommendations (Single Rulebook) and their application in internal procedures and regulations of the competent authorities is a starting point in achieving supervisory convergence. Monitoring, and understanding if the competent authorities apply comparable supervisory practices, is the second component and should consider the degree of flexibility (proportionality, supervisory judgement) used in procedures, methods and the intensity of supervision. The third component of supervisory convergence is comparing supervisory outcomes from the perspective of similar supervisory responses to institutions with similar exposures and risk profiles, in order to achieve consistency in the treatment of institutions across the Single Market.
  
6. In this report, the EBA addresses all of the above elements, by analysing the degree of, and progress in increasing, supervisory convergence in supervisory methodologies in practice (Sections 2 and 3) and discussing convergence in supervisory measures (Section 4). Furthermore, in this report the EBA recaps on the improvements in the functioning of colleges of supervisors that have been analysed in greater detail in the dedicated EBA report<sup>3</sup> (Section 5), and provides updates on the policy developments supporting convergence of supervisory practices (Section 6) and on the training activities (Section 7).

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<sup>3</sup> See EBA Report on functioning of colleges in 2016:  
<https://www.eba.europa.eu/documents/10180/1720738/EBA+Report+on+the+functioning+of+supervisory+colleges+in+2016.pdf/283f550a-1a1d-4b7a-abce-66e8c9b445fb>

# 1. EBA tools for pursuing supervisory convergence and its monitoring

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**In 2017, the EBA has continued to enhance its convergence monitoring and assessment toolkit by further expanding bilateral convergence visits – the tool first introduced in 2016. These visits allow constructive dialogue on the practical implementation of the EBA regulatory products and provide feedback to the EBA policy development process**

## 1.1 EBA and convergence tools

7. The EBA has a number of tools to promote supervisory convergence and implement its convergence strategy, built around three main elements:
  - a. regulatory products;
  - b. training;
  - c. monitoring and assessment.
8. The above elements are complementary and are part of a recursive ‘assess-guide-train’ process. Identification of divergent supervisory practices and supervisory outcomes leads into the development of regulatory products, for which the training tool is used to ensure they are consistently applied.
9. Regulatory and policy products represent a powerful convergence tool, which sets the common standards that competent authorities must follow and comply with. A significant part of the European Single Rulebook is addressed to the competent authorities covering various aspects of supervisory work. This is supported by the Q&A tool, which provides a common interpretation of the Single Rulebook together with possible opinions and recommendations the EBA can issue. EBA guidelines, recommendations and opinions are also used as important regulatory tools to establish consistent, efficient and effective supervisory practices.
10. In addition to the Single Rulebook, the EBA also has the mandate to develop and maintain an up-to-date European Supervisory Handbook that shall set out supervisory best practices for methodologies and processes on the supervision of institutions in the EU.
11. The EBA prepares its training programme in cooperation with competent authorities. Given an increase in demand for supervisory training, the EBA has recently been seeking to extend its training activities by introducing additional tools such as online training and developing a core curriculum for supervisors (see Section 7).
12. Finally, the monitoring and assessment tools can be grouped into four main categories:

- a. peer reviews;
  - b. desk-based reviews;
  - c. college monitoring;
  - d. staff reviews of supervisory practices (bilateral convergence visits).
13. Peer reviews: The peer reviews are conducted by dedicated teams composed of EBA staff and staff from the competent authorities coordinated by the EBA Review Panel. The peer reviews are focused on the implementation and application of the EBA guidelines and technical standards. The topics assessed allow in-depth studies to be done in the form of self-assessment, followed by a review by peers.
14. The peer review process also supports identification of best practices, which can then be used for further policy work; e.g. the peer review of the EBA Guidelines on stress testing contributed to the review of the EBA Guidelines on institutions' stress testing that are currently being published for consultation. In general, these reviews have been effective in checking compliance with guidelines and standards, but less so in driving change in practices and convergence in supervisory outcomes, especially in areas in which there were differences in national laws or regulations. Moreover, it is a relatively lengthy process requiring resources from both the EBA and the competent authorities
15. Desk-based reviews: Desk-based reviews combine the EBA stocktakes with open discussions in the EBA's standing committees (particularly the Standing Committee for Oversight and Practices – SCOP) on different topics that feed into the reviews and identified supervisory priorities. For example, stocktakes on supervisory review and evaluation methodologies in 2012/2013 fed into the development of the new EBA Guidelines on common procedures and methodologies for the SREP. Some of these reviews can be performed by ad hoc teams established on more technical subjects, e.g. review on RWAs' consistency and benchmarking on remuneration.
16. In general, such reviews help identify commonalities and divergences, emerging issues or inconsistencies in supervisory practices and processes, as well as help enhance mutual understanding among supervisors and the identification of methods to tackle these findings. On the other hand, such reviews are typically based on information provided by the competent authorities via questionnaires, which might be a limitation to having a set of neutral and comparable information and can capture a snapshot of practices at a certain moment that may not reflect later developments.
17. College monitoring: Monitoring of colleges of supervisors for the most significant cross-border European banking groups is an ongoing activity performed throughout the year. This allows the EBA to monitor the specific implementation of both specific standards and guidelines addressing colleges, as well as supervisory practices more widely – particularly those concerning the SREP reviews and recovery plan assessments.

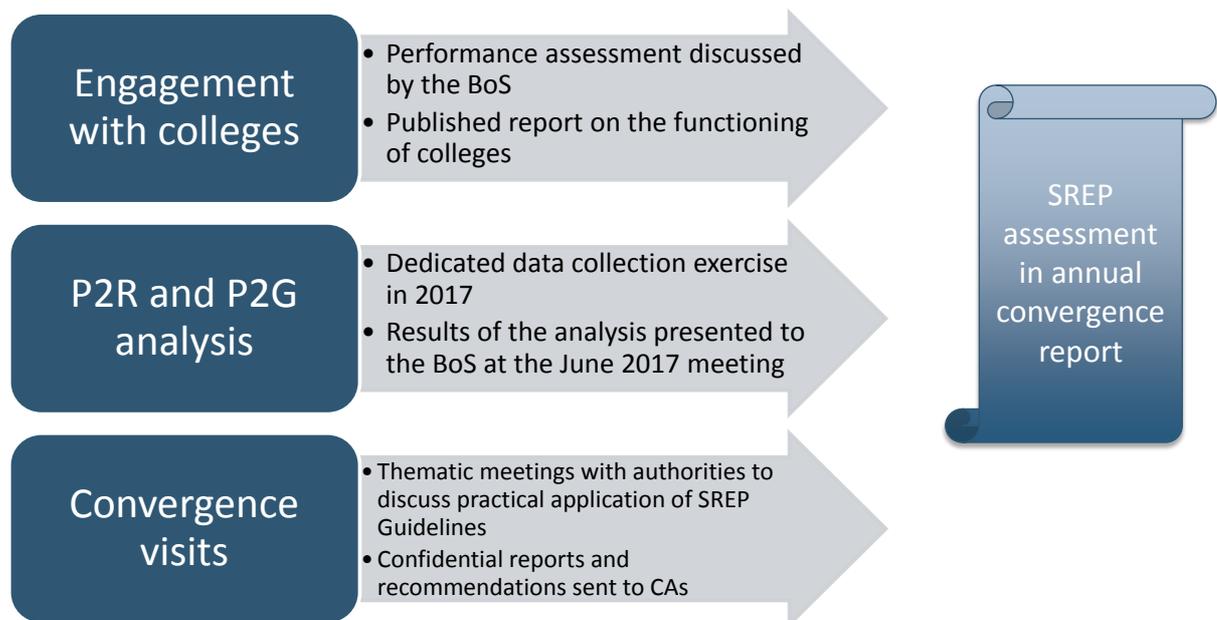
18. Over the years, this monitoring has turned into a structured deep-dive assessment solely based on information collected and activities performed directly by the EBA staff, which is annually summarised in a report on the functioning of colleges to provide a deeper overview of the progress and challenges. This report also helps identify areas for further work on supervisory methodologies.
19. Staff reviews of supervisory practices (or bilateral convergence visits): Staff reviews of supervisory practices employ bilateral interactions between the EBA staff and the competent authorities in order to assess particular aspects of supervisory practices as part of the assessment of supervisory convergence (in accordance with Article 107 of the CRD). This tool enables the EBA to gain a deeper understanding of the application of the Single Rulebook, and is also an opportunity to provide bilateral feedback to the competent authorities subject to such reviews in a confidential manner. This tool was introduced in 2016 as part of the assessment of the implementation of the common SREP framework (see also Section 1.3).

## 1.2 Tools applied for 2017 convergence report and sources of information

20. The EBA applied the above-mentioned tools and relied on relevant sources of information to conduct its assessment of different aspects of supervisory reviews, evaluation and measures in 2016 and first half of 2017, the outcomes of which have been included in this report.
21. In accordance with the scope of convergence assessments pursuant to Article 107 of the CRD, the scope of this report includes the assessment of convergence and the EBA activities to promote and support such convergence in the areas of:
  - a. SREP practices and approaches to the determination of specific prudential requirements on capital and liquidity;
  - b. practices in the assessment of internal governance and its specific aspects (such as remuneration, 'fit and proper' assessments);
  - c. review and benchmarking of internal models;
  - d. assessment of recovery plans.
22. The report has been prepared based on the information obtained through the ongoing activities of the EBA, including participation in the colleges of supervisors, analysis of supervisory methodologies provided to the EBA in accordance with Article 107 of the CRD, and dedicated collection of P2R and P2G data for the sample of the largest institutions (see also Figure 2). Furthermore, the work carried out on assessment and benchmarking of the internal risk models conducted in accordance with Article 78 of the CRD and various benchmarking activities in the

field of internal governance (remuneration practices, diversity practices and number of directorships, time commitments and training of the Boards) have fed into this report.

**Figure 2. Major reference sources for ongoing assessment of convergence in SREP**



23. It is noted that in 2016-2017 the EBA has conducted a formal peer review on supervisory reporting (application of the ITS on Supervisory Reporting (Regulation (EU) No 680/2014)), which focused on the assessment of the processes put in place by the competent authorities in the context of supervisory reporting, such as the procedures and ICT systems used to collect data and ensure data quality, the process of dealing with enquiries by reporting institutions and issues of governance, or measures taken with regard to updates to the reporting framework<sup>4</sup>. As the focus of this peer review lies outside the direct scope of convergence assessment under Article 107 of the CRD, the findings of the peer review are not recalled in this report.

### 1.3 Bilateral convergence visits

24. In 2017, the EBA continued enhancing its bilateral convergence visits. First introduced in 2016, these constitute a powerful convergence monitoring and assessment tool. In 2017, the EBA staff performed a second round of bilateral convergence visits on the application of the SREP Guidelines, and visited 11 competent authorities (3 SSM and 8 non-SSM authorities), focusing on:

<sup>4</sup> See Final Peer review Report of the ITS on supervisory reporting requirements: <http://www.eba.europa.eu/documents/10180/1720738/Final+report+on+peer+review+on+ITS+on+supervisory+reporting.pdf/01eb7247-7566-470c-a3de-5842108e4464>

- a. the implementation of the SREP framework and the follow-up on the 2016 assessment and fulfilment of the consideration and recommendations;
  - b. the implementation and practical application of the BMA methodology included in the SREP Guidelines;
  - c. the setting of P2R and P2G;
  - d. changes to the business models and strategies related to financial innovation and financial technology (FinTech).
25. These convergence visits are seen as a mutually beneficial tool allowing more direct contacts with experts and line supervisors in the competent authorities, helping the EBA to gain a better understanding of the practical implementation of the EBA guidelines by supervisors and thus contribute to the building of a common supervisory culture and practical convergence in supervisory practices. The visits also allow the EBA to identify parts of the guidelines where there might be differences in interpretation, and also identify topics that may require future revisions/updates to the guidelines (e.g. 2016 convergence visits brought to the attention the need to better clarify aspects of scoring, interaction between various SREP elements, and articulation and communication of TSCR and OCR, which has been done in the 2017-2018 revision of the SREP Guidelines; see also Section 6.1.1).

## 2. Convergence in the supervisory review and evaluation process

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### 2.1 Status of the implementation of SREP Guidelines

**In 2017, a good degree of progress has been made by competent authorities in the implementation of the SREP Guidelines as well as in taking forward recommendations and observations made by the EBA during the 2016 bilateral convergence visits. There are, however, challenges remaining, primarily in the areas of the methodologies for capital adequacy assessments and the determination of institution-specific additional own funds requirements. This is most clearly illustrated by the different approaches to using ICAAP, the disparity of risk taxonomies, and differences in the transparency of setting P2R where it is not based on the risk-by-risk determination. In turn, this leads to differences in the articulation and communication of P2R to supervised institutions.**

**Many of the aspects identified in the 2016 convergence assessment are also being reflected in the EBA policy work on Pillar 2 leading to the update of the SREP Guidelines (e.g. using stress testing in capital adequacy assessment, clarification of the role of viability scores).**

26. The key focus of the EBA convergence monitoring and assessment is on the supervisory practices in the SREP, as this brings together outcomes of all supervisory activities within the ongoing supervision of the institutions. The EBA has set out the comprehensive common European SREP framework in its Guidelines on common procedures and methodologies for SREP (SREP Guidelines), which were published in December 2014 and apply from 1 January 2017. The SREP Guidelines provide a common framework for the supervisory assessment of the institutions' viability while focusing on the assessment of their business models and strategy, internal governance and institution-wide controls, risks to capital and capital adequacy, risks to liquidity and funding, and liquidity adequacy. The Guidelines also set out the common approach to the determination and articulation of TSCR and institution-specific liquidity requirements<sup>5</sup>.
27. As the SREP Guidelines provide a solid basis for all competent authorities to build their own assessment methodologies and practices, the SREP Guidelines also provide a common reference point for the EBA's assessment of convergence. Quite naturally, in its assessment of convergence in SREP the EBA pays great attention to how competent authorities across the EU have implemented SREP Guidelines and apply them in practice.

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<sup>5</sup> See: <http://www.eba.europa.eu/regulation-and-policy/supervisory-review-and-evaluation-srep-and-pillar-2/guidelines-for-common-procedures-and-methodologies-for-the-supervisory-review-and-evaluation-process-srep->

28. As reported in the 2016 EBA convergence report<sup>6</sup>, in relation to the implementation of the SREP Guidelines, in 2016 it was concluded that in general the SREP process and overall methodology implemented by the competent authorities are largely in line with the SREP Guidelines and all the authorities have taken into consideration the new common framework in reviewing the previous methodology, although to different extents (it was noted then that authorities could be broadly categorised into three groups: (1) those that have largely implemented the Guidelines, (2) those that have partially implemented the Guidelines and (3) those that have not implemented the Guidelines).
29. Looking in more detail at the individual elements, however, several areas of improvements have been identified that require further development and refinement by competent authorities. The areas with most problem turned out to be the approach to the application of SREP scoring, in particular viability scoring; the use of stress testing in capital adequacy assessment and setting P2R and approaches to the determination of TSCR.

The 2017 round of the assessments suggests that most of the authorities have made significant progress with further implementation. In particular, authorities made significant progress in improving their SREP process, categorisation of institutions and defining the engagement model. The EBA also witnessed some improvements in the approaches to scoring, with more authorities turning to using the viability scoring concepts introduced in the SREP Guidelines. While the areas of capital adequacy assessment and determination of TSCR still remain troublesome from the supervisory convergence perspective, the degree of convergence is also improving there, as authorities have been implementing the recommendations that EBA staff made on the basis of 2016 convergence visits. The further policy developments in the Pillar 2 area have also helped, notably the introduction of legally non-binding P2G to address the outcomes of stress testing.

### Detailed observations on capital adequacy assessment

30. Significant improvements have been observed in 2017 in the convergence of practices in the SREP areas of capital adequacy assessment and determination and articulation of TSCR (see also Section 4 for more detailed analysis of quantitative outcomes in terms of P2R and P2G):
- a. Composition and articulation of TSCR: As explained in the 2016 convergence report, there was concern regarding some authorities' practices of articulating and communicating to institutions P2R about only CET1. Although requiring institutions to hold only CET1 instruments to meet their TSCR is in line with the SREP Guidelines, not communicating all other applicable capital ratios created uncertainty for institutions. Following the bilateral engagement with the competent authorities in question and additional clarification work as part of the revision of the SREP Guidelines (see Section 6.1.1), the EBA observed significant improvement in 2017; all capital ratios affected by TSCR were clearly communicated to the institutions by the authorities that do communicate TSCR.

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<sup>6</sup> See:

<http://www.eba.europa.eu/documents/10180/1360107/EBA+report+on+the+convergence+of+supervisory+practices/98bb6076-7c12-4711-bda2-14552f4e477d>

- b. Interplay between TSCR and the combined buffer: As explained in the 2016 report, for some authorities an overlap between P2R and some elements of the CRD combined buffer was observed. Notably, based on the unjustified assumption of full overlap between elements of SREP and the capital conservation buffer requirement, some authorities were considering the CCB as part of P2R. This was motivated by the need to smooth the divergences in early phase-in of the CCB by some Member States. This practice risked creating confusion for the institutions and investors between binding requirements (P2R) and ‘useable’ buffers; the imposition of the latter is not based on the SREP assessment. Following the bilateral engagement with the affected authorities, and further policy work on Pillar 2 topics, including in preparation for the revising of the SREP Guidelines, in 2017 the EBA observed that all authorities are considering the CCB as part of the CRD combined buffer, namely on top of TSCR, so they are not assuming any overlaps between the CCB and P2R.
- c. Interplay between TSCR and restrictions on distributions: Following the clarification of the role of TSCR and, in particular, legally binding P2R in the context of triggering and factoring into the calculation of MDA under Articles 141-142 of the CRD as explained in the EBA Opinion on MDA<sup>7</sup>, in its 2016 convergence report the EBA reported some instances where authorities did not fully follow the MDA Opinion, as TSCR was not applied in legally binding and directly enforceable form, or MDA calculations disregarded P2R. As explained in the 2016 convergence report, different approaches to MDA triggers and calculation create an uneven playing field and lead to investors’ uncertainty. In 2017, the EBA continuously engaged with the affected authorities and supported the Commission’s proposal for review of Article 141 as part of the CRD review (CRD V).
- d. Use of stress testing: During the 2016 convergence visits, the EBA staff observed some divergences across supervisory practices in the use of outcomes of stress tests as well as stressed supervisory benchmarks and their quantitative outcomes for the purposes of capital adequacy. Some authorities factored such outcomes on top of the combined buffer requirements, while others incorporated them directly into P2R. Following the extensive policy development work leading to the introduction of the common approach to using outcomes of stress tests in the capital adequacy process resulting in setting legally non-binding P2G as explained in the EBA Pillar 2 Roadmap<sup>8</sup> (see also Section 6.1.1), in the 2017 convergence visits the EBA staff confirmed that the stress perspective element has been separated out from P2R and it is now part of P2G.
31. Despite the notable improvements in the capital adequacy assessment and TSCR determination process discussed above, this SREP element remains a concern for the EBA. More convergence should be reached in this area. Thus, the EBA continues to see problems that were previously reported in the 2016 convergence report, related to, inter alia:

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<sup>7</sup> See: <https://www.eba.europa.eu/documents/10180/983359/EBA-Op-2015-24+Opinion+on+MDA.pdf>

<sup>8</sup> See: <https://www.eba.europa.eu/documents/10180/1814098/EBA+Pillar+2+roadmap.pdf>

- a. differences in the approach to the determination/calculation of P2R, where some authorities base their determination on the holistic approach not supported by the risk-by-risk quantification;
- b. differences in the role played by ICAAP in the determination/calculation of P2R, and, in particular, some authorities setting P2R solely on the basis of supervisory benchmarks or supervisory judgements even where ICAAP was assessed as reliable;
- c. not using P2R to address the possibility that internal models underestimate risk;
- d. not using P2R in addressing governance and control deficiencies.

## 2.2 Focus on specific SREP element: business model analysis

**There is a good degree of convergence in the implementation of the business model analysis element of the common SREP framework, with the EBA observing a number of good practices going beyond the SREP Guidelines.**

32. The EBA SREP Guidelines have introduced BMA as one of the main SREP elements requiring competent authorities to form supervisory views on business and strategic risks by assessing the institution's business model viability and sustainability. This component of the SREP is important for embedding a forward-looking perspective in supervisory work, linking together all the other components, from the assessment of risks and governance to capital and liquidity adequacy, and stretching beyond the SREP to the determination of the likelihood of failing and the adequacy of recovery plans.
33. A deeper review of this SREP element, also prompted by the supervisory focus on banks' business models and their performance in and adaptations to the low interest rate environment, has been incorporated into the 2017 round of bilateral convergence visits.
34. Generally, the EBA found that competent authorities assessed have broadly implemented the common approach to BMA, as outlined in the SREP Guidelines and Supervisory Handbook module on BMA, in their methodologies and practice, and the supervisors showed a good understanding of their respective banks' business models and strategies, as well as the risks stemming from them. The key aspects of the evaluation of banks' current business models are being considered and the strategic plans are being challenged in the context of the markets in which the institutions operate.
35. Although there are no material issues in the application of the BMA, in some cases the EBA noted that there are differences in the BMA approaches adopted by the competent authorities, notably in setting the focus and scope of their analyses. In some cases, the BMA was limited only to the consolidated level and authorities did not take due account of the assessment of material business/product lines or the geographies in which institutions operate. Furthermore,

the EBA observed some lack of a structured approach to the quantitative analysis, including the analysis of the institutions' own financial forecasts, and the selection of peer groups for BMA purposes; authorities did not always tailor peer groups to the focus of the analysis, taking into account information on business/product lines.

36. Regarding the supervisory measures applied based on the outcomes of the BMA, while in most of the cases competent authorities resort to using BMA to better structure their interactions with institutions and challenge their financial projections and strategic plans, or rarely apply qualitative supervisory measures applied as part of the overall SREP response, the EBA identified some authorities that set P2R for business and strategic risk based on the outcomes of the BMA. The latter practice raises concerns over the common approach to the implementation of the SREP Guidelines, as the Guidelines do not envisage a direct link between BMA findings and setting P2R. As a response to findings and concerns about BMA, the SREP Guidelines suggest reviewing business or capital plans. In this case, they generally limit P2R to only temporary measures when identified governance concerns are not addressed. The EBA, however, will further investigate these cases and its Pillar 2 policy work will incorporate the identification of a common approach to addressing BMA by capital measures (P2R or P2G).
37. Most of the authorities stated that embedding the BMA in the SREP has brought added value to their analysis. It explicitly added the viability and sustainability of the business model and strategy to the overall assessment, thus further enhancing the forward-looking character of the SREP.
38. The EBA staff also observed that some authorities showed good practices in the BMA assessment that go beyond the SREP Guidelines (see Table 1). These can be used as an example to others and also shared by means of a dedicated workshop that the EBA will be organising for the competent authorities. They could lead to an update of the BMA module of the EBA Supervisory Handbook.

**Table 1. Overview of practices that can be identified as 'good practices' in BMA**

Topic	Good practices
Methodology – qualitative analysis	A <b>self-assessment questionnaire</b> helps to assess the qualitative aspects of the BMA. The banks are requested to submit this in order for the supervisors to develop an understanding of the bank's success drivers and key dependences, as well as assumptions, plausibility and riskiness of the bank's business strategy.
Methodology – qualitative analysis	There is a <b>stress test</b> scenario that incorporates a more business model dynamic into it and takes a longer-term view of the bank's position (10 years). This scenario assumes tight margins due to low interest rates, new FinTech companies, changes in payment requirements (PSD2), Brexit and volatility. This is a top-down scenario and the aim is to analyse the impact on the business model and strategies of the banks; however, this is not a pass or fail exercise.

Methodology – quantitative analysis	Supervisors use different methods to challenge the banks regarding their own forecasts. One example is the calculation of <b>3 years’ supervisory projections</b> , which are reviewed annually. All elements of the forecasts, including macroeconomic assumptions, are discussed with the banks. Both banks and line supervisors receive conclusions on the discussions and assumptions. A lot of analysis is done around the interest rates and margins, both for pricing and for overall market conditions. Another example is an ad hoc <b>data collection on budget forecasts</b> used for thematic reviews and BMA.
Methodology – quantitative analysis	There is an <b>alert system</b> designed to compare the values of the indicators of a particular bank with those of the peer group, but it also ensures historical comparison with its own ratios to detect changes over time. Once an alert is generated, it is the line supervisor’s responsibility to investigate the reason for the alert and provide an explanation in a regular report.
Methodology – use of peer groups	The banks are <b>classified into peer groups, using a dynamic approach</b> , once a year, through a top-down assessment. This selection is based on a list of ratios and their thresholds, as well as supervisory judgement.

## 2.3 Assessment of internal governance and institution-wide controls

39. The CRD sets out requirements for institutions’ internal governance arrangements and in particular for the management body, the suitability of its members, risk management and the remuneration of staff whose professional activities have a material impact on the institution’s risk profile. Competent authorities assess within their supervisory review that institutions meet these requirements at authorisation, but also on an ongoing basis through the SREP assessment of internal governance and institution-wide controls. In addition, competent authorities and the EBA regularly benchmark diversity and remuneration practices.

### 2.3.1 Remuneration practices

40. As part of the SREP assessment of internal governance and institution-wide controls, competent authorities also assess the adequacy of institutions’ remuneration practices and their compliance with the requirements of Articles 92-95 of the CRD and the relevant RTS and EBA guidelines.

41. The EBA is required to publish aggregated data<sup>9</sup> on high earners earning EUR 1 million or more per financial year. The EBA has analysed the data provided to it for the year 2015, and compared them with the 2014 data. The main results show that the number of high earners who were

<sup>9</sup> See: <https://www.eba.europa.eu/documents/10180/1720738/EBA+Final+Report+on+High+Earners+2015.pdf>

awarded EUR 1 million or more in annual remuneration increased significantly, from 3 865 in 2014 to 5 142 in 2015 (+33.04%). This was mainly driven by changes in the exchange rate between EUR and GBP, which meant that staff incomes paid in GBP was equivalent to more EUR.

42. In addition, the data show that the proportion of high earners who were staff identified as having a material impact on the institution's risk profile was almost the same as in 2014. Around 86% of high earners in 2015 were identified staff, versus 87% in 2014. This confirms that the percentage increased significantly after the RTS on identified staff entered into force in 2014 (it was 59% in 2013). The average ratio of variable to fixed remuneration for all high earners has increased from 127% in 2014 to 147% in 2015. However, the maximum ratio of 200% set out in the CRD is largely exceeded within asset management, for which the average ratio of variable to fixed remuneration is 468%. This is due to waivers granted for this business area in several Member States.
43. The EBA continues to monitor the development of remuneration practices and trends and has collected data for the financial years 2015 and 2016 from approximately 150 institutions. The report on the results is expected in Q1 2018 and will be published together with the high-earner data for the financial year 2016.

### 2.3.2 EBA benchmarking of diversity practices at European Union level

44. In July 2016, the EBA published a benchmarking analysis of diversity practices at EU level<sup>10</sup>. In particular, the report analyses the diversity policies put in place by institutions for the effective diversity of boards as well as future diversity targets. The EBA collected data from 873 institutions from 29 EU and EEA Member States, representing 14.30% of 6 103 institutions in those Member States, separately for credit institutions of different sizes and for investment firms.
45. Despite the legal requirements, only a limited number of institutions have already adopted a diversity policy. The policies adopted differ significantly between Member States, particularly regarding the aspect of gender diversity targets. Institutions' diversity policies should actively facilitate a diverse composition of the management body.
46. In addition, the actual level of diversity in the composition of the management body in institutions differs significantly between Member States, particularly regarding gender diversity. The representation of women within management bodies is very low (13.63% in the management function and 18.90% in the supervisory function). Within smaller institutions that have smaller numbers of members of the management body, diversity within the management body is lower. However, it has to be taken into account that, the smaller an institution's management body, the more difficult it is to achieve a broad range of diversity within the management body. Furthermore, small investment firms are typically run by the owner, which,

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<sup>10</sup> See: <https://www.eba.europa.eu/documents/10180/1360107/EBA-Op-2016-10+%28Report+on+the+benchmarking+of+diversity+practices%29.pdf>

by its nature, makes it impossible to achieve a diverse composition of executive directors. More than two thirds (69.42%) of institutions have executive directors of only one gender. Institutions, but also Member States, should consider additional measures that would promote a more balanced representation of both genders.

47. Diversity concerns regarding the age of directors exist for only a limited number of institutions. The same holds true for the aspect of geographical provenance, which can mainly be a concern for large, internationally active banks. Diversity with regard to educational and professional background is linked to the management bodies' collective 'fit and proper' standing, and is, therefore, already better developed in many institutions than other aspects of diversity.
48. The EBA will continue to monitor the development of diversity in management bodies and issue periodical benchmark studies.

### 2.3.3 EBA benchmarking regarding the number of directorships, time commitment and training

49. In order to inform the development of the guidelines mandated under Article 91(12) of the CRD, in 2015 the EBA collected data from a broad range of institutions on the numbers of directorships held and the time committed by the members of their management bodies. In addition, data on training resources were collected. The results<sup>11</sup> of the analysis were published together with the consultation paper on the draft Guidelines on 'fit and proper' in October 2016.
50. The EBA analysed the time committed by members of the management body, separately for the management function (executive directors), for the supervisory function (non-executive directors) and for members holding different functions. For some members and institutions, the data raise concerns over whether or not the members of the management body can actually commit sufficient time, given the number of mandates they hold. The data show also that, as expected, the time commitment of the chairperson is significantly higher than that of other members. The analysis shows also that there is no strong correlation between the size of the institution and the number of days committed.
51. In addition to the obligation to commit sufficient time, members of the management body of significant institutions are required to hold not more than a certain number of directorships as counted under Article 91(3) and (4) of the CRD. This limitation could have an impact on the number of directors that are potentially available to fill a position. When counted in accordance with Article 91(3) and (4) of the CRD, almost 30% of executive directors report holding more than one executive directorship, and more than 10% report holding more than two. Only around 8% of non-executive members of management bodies reported having more than three non-executive directorships, and fewer than 5% have more than five.

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<sup>11</sup> See:

<https://www.eba.europa.eu/documents/10180/1639842/Consultation+Paper+on+Joint+ESMA+EBA+Guidelines+on+suitability+of+management+body+%28EBA-CP-2016-17%29.pdf>

52. A large number of the institutions of the sample have a framework to provide training to members of the management body. For many institutions, there is also the possibility of using training facilities provided by the industry associations. The remainder of the institutions (21%) have no framework for training of members of the management body in place, but should introduce one as a requirement of the CRD.

## 2.4 Ongoing review of internal models and supervisory benchmarking

**The EBA has significantly expanded the scope of its benchmarking and analysis work to cover all institutions that have permission to use advanced models for calculating own funds requirements for credit and market risk. The EBA analysis tool and benchmarking data are more widely used than previously by the competent authorities in their ongoing monitoring of the performance of advanced models. The analysis shows clear heterogeneity in the results, which is also caused by the lack of sufficient historical data for the analysis due to the major expansion of the sample of institutions and the switch to the use of new common definitions.**

53. The EBA has been conducting several annual EU-wide supervisory benchmarking exercises for internal models in recent years in the context of the RWAs' consistency<sup>12</sup> and comparability for credit and market risk, in accordance with Article 78 of the CRD. The broader objectives are to identify any material differences in RWA outcomes that underlie the observed divergences from the internal models, to understand the sources of such differences and, if necessary, to formulate the necessary policy solutions to enhance convergence between institutions and to improve disclosure. The outcomes prompted in 2015 the definition of a mid-term project intended to repair IRB models<sup>13</sup> for credit risk, further referred to in Section 6.4.1.
54. The EBA EU-wide supervisory benchmarking exercises for internal models has been assisting the competent authorities in the authorisation and review of internal models by providing a regular supervisory assessment tool, by being a key component of validation for supervisors and institutions and by helping them to understand divergences and comparability in risk weights.
55. Benchmarking is a regular EU-wide supervisory tool, covering the entire population of institutions authorised to use internal models for calculating own funds requirements (i.e. more than 130 institutions at the highest level of consolidation). The EBA has been calculating and delivering benchmarks at very granular level to support the on-site and off-site supervisory work of the competent authorities on the assessment of the internal models applied by the institutions for credit and market risk. These benchmarks help to identify internal models that

<sup>12</sup> 'Review on the consistency of Risk Weighted Assets': <https://www.eba.europa.eu/risk-analysis-and-data/review-of-consistency-of-risk-weighted-assets/-/topic-documents/DjOTmcAgAa0J/more>

<sup>13</sup> The paper is available on the EBA website: <https://www.eba.europa.eu/documents/10180/1003460/EBA-DP-2015-01+DP+on+the+future+of+IRB+approach.pdf>

show significant deviation of risk parameters and RWAs from peers and potential significant underestimations.

56. The reports<sup>14</sup> published in 2017 present the outcomes of the analyses on benchmarks for high default portfolios (HDPs), namely residential mortgage, SME-retail, SME-corporate and corporate portfolios, as well as for market risk, with the objective of identifying the main divergences, investigating the causes and providing competent authorities with useful inputs for their internal model reviews.

#### 2.4.1 Main findings on the outcome of the review of internal models

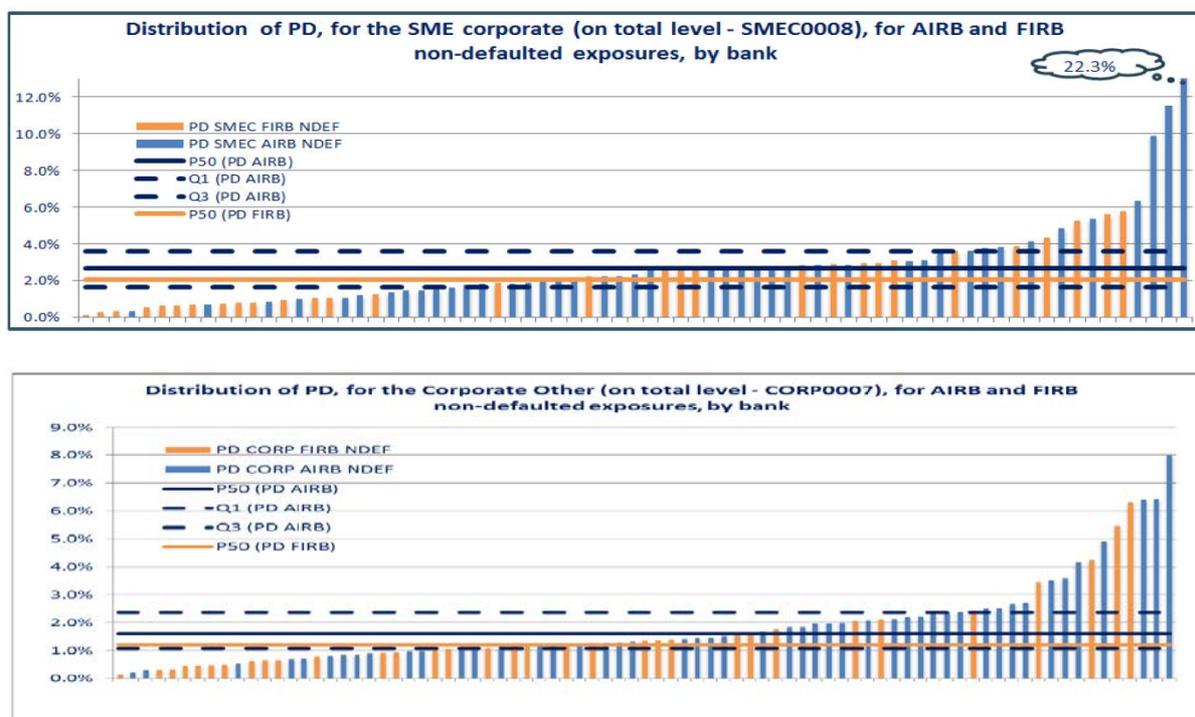
57. For credit risk, the most recent report analysed, in particular, the internal models used for estimating the credit risk parameters (PD, LGD and EAD) of exposures in the residential mortgage, SME-retail, SME-corporate and corporate portfolios. The reference date for the data is 31 December 2015, and 114 institutions participated in this exercise across 17 EU countries.
58. The outcomes on the benchmark portfolio used for credit risk showed that the results are broadly in line with those of previous exercises on HDPs. Overall, the GC<sup>15</sup> increased – compared with previous exercises – to, on average, 75% (67% in the 2013 HDP report, which involved a smaller sample of larger banks). The GC variability is also greater than in previous exercises, ranging from 8% to 293% (14% to 174% in the 2013 HDP report). The RW average per institution varies from 7% to 129%, with a simple average of 37.3%.
59. A key finding is that a large part of the observed GC variability can be explained by only a few factors, namely the proportion of defaulted exposures, the proportion of non-EU exposures and the portfolio mix. This confirms previous findings that RWA variability can be explained, to a large extent, by looking at some measurable features of banks' portfolios.
60. A cross-sectional (distribution analysis) approach was used to take an in-depth look at risk parameters and portfolios. For EU non-defaulted exposures, the RW interquartile ranges show significant variability per portfolio, in particular for the two asset classes SME corporate and corporate-other. The country of the counterparty is an important driver of RW variability. For different asset classes, the interquartile ranges broken down by country of the bank are in line with the EU benchmarking figures; however, they are higher in some EU countries. For risk parameters, there are differences between the FIRB and AIRB approaches (i.e. LGDs under the AIRB approach seem, in general, to be lower than under the FIRB approach, whereas the PDs for the FIRB approach are smaller than for the AIRB approach; Figure 3). Given the lower LGDs and CCFs for banks under the AIRB approach, possible compensations based on the estimation of PDs may be a reason for lower PDs under the FIRB approach.

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<sup>14</sup> 'EBA publishes its regular assessment of EU banks internal model outcomes': <https://www.eba.europa.eu/-/eba-publishes-its-regular-assessment-of-eu-banks-internal-model-outcomes>

<sup>15</sup> GC, for IRB exposures, is computed as  $(12.5 * EL + RWA) \div EAD$ .

Figure 3. PDs (%) and the EU PD benchmarks by regulatory approach (FIRB and AIRB), by bank



61. In addition, the outturn ('backtesting') approach compares observed values with estimated values for the individual banks. The estimated values for PDs and LGDs are, in general, higher than the observed default rates and loss rates, which suggests that banks are, on average, conservative. However, some banks present observed values (latest year and the average of the last 5 years) of defaults and losses above the estimated values of PDs and LGDs. The analysis confirms that the country of the reporting bank and of the counterparties is an important driver of RW variability for HDPs and this may be due not only to the underlying risk but also to bank and supervisory practices.
62. As highlighted in previous reports and confirmed in interviews with several banks and competent authorities' assessments, there is still a wide range of practices with regard to the definition of 'default' and the treatment of defaulted assets. These differences are particularly important when comparing FIRB institutions, where RW should be zero, with AIRB institutions, where LGD best estimates are used. These factors should, however, gradually disappear with the implementation of the RTS on the assessment of internal approaches and on default definition (see more details in Section 6.4.2).
63. For the market risk (CCR and CVA), the exercise was performed on a sample of 50 institutions from 12 EU countries. The report presents the observed variability measures in terms of IQD<sup>16</sup>. As in the previous exercises on MRWA variability, significant dispersion for all the risk measures provided by banks is observed in the IQD metric. From a risk factor perspective, interest rates

<sup>16</sup> IQD is defined by the interquartile range  $\{(Q3 - Q1) \div 2\}$  divided by the average of the quartiles  $\{(Q3 + Q1) \div 2\}$ , called the mid-hinge. The higher the IQD, the higher the dispersion in the data.

show a lower level of variability than the other asset classes because of the more consistent practices and more homogeneous assumptions used across the banks for modelling interest rate risk. The analysis shows high dispersion in the IMV results because of the different interpretations and market practices adopted by banks. Some of these issues have been addressed and the quality of the data has improved thanks to successive resubmissions. The evidence collected will be taken into account in future exercises dealing with banks' pricing techniques, especially for complex derivatives, to achieve more harmonisation. Regarding the single risk measures, across all asset classes, as expected the overall variability for VaR is lower than that observed for sVaR (respectively 23% and 30%). More complex measures such as IRC and APR show much higher levels of dispersion (respectively 42% and 52%). These findings are in line with those of previous exercises, so they have the same implications.

#### 2.4.2 Main findings on the use of EBA benchmarking by the competent authorities

64. The EBA also assessed how competent authorities use the outcomes of the supervisory benchmarking analyses as described above.
65. For credit risk, and for the majority of the banks, the RW deviations from the EU benchmarks were deemed by the competent authorities to be justified and not significant. In the remaining cases, the assessment shows that residential mortgages are deemed to be one of the most important portfolios to monitor because of their importance for banks and their potential impact on RWAs. Competent authorities also consider that both corporate-other and residential mortgage portfolios present the highest numbers of possible underestimations when using benchmarking values, for which there are no immediate justifications, and comprehensive analyses are necessary with possible supervisory actions. The report also highlights that banks' internal validations had not identified most of the potential underestimations. By contrast, most competent authorities noted that possible underestimations were identified in advance, in particular for both corporate-other and SME corporate portfolios, and that supervisory actions were being taken to address such issues. From this perspective, the answers were encouraging and the exercise helped to identify issues for the actions by the competent authorities.
66. With regard to market risk (CCR and CVA), the EBA noted that, for some identified outlier institutions, their respective competent authorities have already planned some actions as part of their ongoing model-monitoring activities. Among some areas that may require further investigation by competent authorities are the accentuated pricing variability for equity derivatives, commodities trades and credit spread products. Generally, FX trades and credit spread portfolios show more dispersion than other asset classes for the analysed risk metrics. Supervisors should pay attention to credit VaR models by challenging both VaR and sVaR assumptions and modelling choices. Similarly, particular attention has to be dedicated to any model extension to FX derivatives. Furthermore, competent authorities should assess the materiality of risk factors not in VaR ('risk not captured by the model') and, where appropriate, challenge the models to improve the coverage (e.g. through internal model authorisation extension). For IRC models, supervisors should ensure that banks review the transition matrix in a prudent and appropriate way.

67. Overall, the benchmarking showed that there are still differences in internal estimates of risk and that, in some cases, these can materially affect the comparability of RWAs and therefore the capital requirements. The overall results of the review on RWAs are informing the work that the EBA is conducting in parallel on the validation of internal models, which is also contributing to harmonising supervisory and banks' practices and to enhancing consistency. These include using existing EBA guidelines, where appropriate, to enhance convergence in the computation of RWAs, and to improve Pillar 3 disclosures, as well as validating and continuing to monitor internal models.

## 3. Convergence in assessment of recovery plans

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**EBA continues its benchmarking analysis of institutions' recovery plans and sees significant improvements in the quality of recovery plans. The experience gained in the assessment of recovery plans and the discussion and joint assessment of them in the colleges has led the EBA to clarify the approaches to the assessment of the plans by updating its Handbook module on the assessment of recovery plans and also issuing recommendations on the coverage of entities in the group recovery plans.**

68. The assessment of recovery plans and deciding on relevant remediation measures have now become a significant part of the regular supervisory activities, which also feeds into the element of the SREP framework about assessment of internal governance and institution-wide controls. Over the past year, EU supervisory colleges underwent the second cycle of assessment of group recovery plans for cross-border institutions under the regulatory framework introduced by the BRRD in January 2015.
69. In general terms, the approach undertaken by the competent authorities showed a fair degree of convergence both in the assessment process and criteria in the group recovery plans (to a large extent thanks to the EBA Supervisory Handbook module on supervisory assessment of recovery plans, providing common guidance to competent authorities) and in the identification of the main deficiencies, although some differences persisted, especially with respect to the treatment of individual entities in the group recovery plans of cross-border banking groups.
70. The EBA continues its ongoing work in identifying and promoting better and more consistent practices, both through dedicated assistance and support to supervisory colleges and through appropriate benchmarking analysis.

### 3.1 Comparative reports on recovery planning

71. Within this role of promoting consistency as well as monitoring quality and progress of recovery plans, the EBA issued two thematic comparative reports on recovery planning: one focusing on governance arrangements and recovery indicators<sup>17</sup> (July 2016), and the other on recovery

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<sup>17</sup> See:

[https://www.eba.europa.eu/documents/10180/1360107/EBA+BS+2016+Comparative+report+on+RP+governance+and+indicators\\_July+2016.pdf](https://www.eba.europa.eu/documents/10180/1360107/EBA+BS+2016+Comparative+report+on+RP+governance+and+indicators_July+2016.pdf)

options<sup>18</sup> (March 2017). Both reports provide detailed analysis of practices applied by large European cross-border groups in their recovery plans. Moreover, they outline the best practices and identify key shortcomings in analysed aspects of recovery plans. Therefore, the reports include useful benchmarks supporting institutions in developing high-quality recovery plans as well as supporting supervisors in assessing these plans in a more consistent way.

72. These comparative reports on recovery planning followed two earlier benchmarking reports published in 2015, which focused on the determination of critical functions and core business lines<sup>19</sup>, and the approaches taken on recovery plan scenarios<sup>20</sup>.
73. The key conclusions from the EBA comparative report on governance arrangements and recovery indicators framework can be summarised as follows:
- a. Sound practices were applied by most institutions analysed, in terms of process description, with the approval of the highest group management bodies and contributions from a broad array of internal specialists. The main area for improvement was the limited involvement of local management in developing and updating the group plan.
  - b. Most institutions strove to integrate recovery plans into existing governance arrangements. However, some clarification could be added on which arrangements should be applied at different stages of deteriorating financial positions; the main deficiencies were identified in:
    - i. not meeting the BRRD requirement to notify relevant competent authorities after the escalation procedure is triggered by the breach of recovery indicators (not only in cases when the institution decides to apply recovery options);
    - ii. lack of sufficient details about the interaction between escalation and monitoring procedures applied at the group and local levels.
  - c. In general, institutions established a broad set of recovery indicators and integrated them into their risk management framework; on the other hand, many banks limited their recovery indicators to only two categories (capital and liquidity), whereas the remaining categories (asset quality, profitability, market-based indicators, macroeconomic indicators) were considered only as early warning signals. Another challenge was given by the calibration of recovery indicators at levels consistent with SREP requirements for capital and liquidity indicators.
74. The comparative analysis of recovery options showed that, in the majority of cases, institutions have well understood the importance of having a detailed analysis of options in their recovery plans. With the progress made in providing a good range of credible and feasible recovery

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<sup>18</sup> See: <https://www.eba.europa.eu/documents/10180/1720738/EBA+Comparative+report+on+recovery+options++March+2017.pdf>

<sup>19</sup> See: <http://www.eba.europa.eu/documents/10180/950548/EBA+Report+-+CFs+and+CBLs+benchmarking.pdf>

<sup>20</sup> See: <http://www.eba.europa.eu/documents/10180/950548/Report+on+benchmarking+scenarios+in+recovery+plans.pdf>

options to restore the viability of an institution in a situation of financial distress, there are still areas for improvement and specific issues that might need further development. In particular:

- a. The credibility and effectiveness of recovery plans could benefit greatly from a more detailed analysis of the links between recovery options and governance arrangements, and of the feasibility of options under each scenario.
- b. While all analysed recovery plans provided a financial impact assessment on key supervisory ratios, a number of recovery plans did not provide enough information on the assumptions used to support the valuation of options.

### 3.2 Treatment of individual entities in group recovery plans

75. Both benchmarking reports showed that the inclusion of specific metrics for relevant entities, together with the availability of recovery options at the level of individual entities, was still a challenge for many group recovery plans. More generally, three main issues have been identified from the EBA's thematic reviews of recovery plans and observations from its regular attendance at several colleges of supervisors.
76. First, the vast majority of group plans were developed predominantly from the parent undertaking's perspective, with little emphasis on other entities in the group<sup>21</sup>. Focusing only on the parent undertaking clearly limits the credibility and the effectiveness of the group recovery plan, undermining the overarching aim of identifying measures that may be required to be implemented at the level of the parent undertaking and each individual subsidiary.
77. Second, before the entry into force of the BRRD, some competent authorities used to request individual plans from subsidiaries of cross-border groups in their jurisdiction, and therefore could have detailed information on recovery arrangements. Relying on the group plans – especially if they provide little focus on the subsidiaries – and at the same time giving up the individual plans they had previously received before the BRRD clearly leaves a gap in their understanding of the recovery procedures and measures of the institutions they supervise. While the lack of such information in and of itself should be seen as more a deficiency of the group plan rather than a justification for requesting individual plans, there have been instances where competent authorities have requested individual plans for subsidiaries because the group plan lacked information or adequate coverage.
78. Third, there has been a degree of inconsistency in applying the EU legislation when taking joint decisions on the assessment of group recovery plans. In practice, these decisions should consider:

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<sup>21</sup> It should be noted that Article 7(1) of the BRRD provides that the group recovery plan shall consist of a recovery plan for the group headed by the Union parent undertaking as a whole and that the plan shall identify measures that may be required to be implemented at the level of the Union parent undertaking and each individual subsidiary.

- a. the level of information that should be included in a group plan to meet colleges' expectations of appropriate coverage of the group and its entities;
  - b. the depth and the extent of coverage for each individual subsidiary. Here, the EBA notes that Article 7(1) of the BRRD provides that 'the group recovery plan shall identify measures that may be required to be implemented at the level of the parent undertaking and each individual subsidiary'.
79. All these issues have often led to difficulties in reaching joint decision on group recovery plans and have led to frequent disagreements between competent authorities, and in several cases to having individual decisions in the absence of a joint decision.
80. In order to promote convergence of practices and avoid a fragmented approach to obtaining information on groups and relevant entities, in November 2017 the EBA issued Recommendations on the coverage of entities in group recovery plans<sup>22</sup>. The Recommendations acknowledge that the coverage of all entities needs to be proportional, clarifying that not all entities may require the same level of detailed commentary and to this extent different categories of entities should have different levels of coverage by the elements of the recovery plan.
81. The EBA is of view that these Recommendations should help achieve more convergence in how recovery plan information is organised and conveyed to the competent authorities through the following:
- a. setting out a common framework that could fulfil the needs of the consolidating supervisors, home and host competent authorities when assessing the group recovery plan;
  - b. helping competent authorities reach a joint decision, by providing guidance to the institutions on the level and type of coverage that should be included in group recovery plans for different types of individual entities in the context of Article 7 of the BRRD;
  - c. increasing the quality of group recovery plans, including some transitional provisions to enable the institutions to incorporate information from existing individual plans into the comprehensive group plans in the timeline agreed by the relevant competent authorities.

### 3.3 Simplified obligations for recovery and resolution planning

82. The European crisis management framework is in principle applicable to all institutions, ranging from G-SIIs/O-SIIs to very small entities. However, in line with the principle of proportionality, according to Article 4(1) of the BRRD, competent authorities and resolution authorities may apply

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<sup>22</sup> See: <https://www.eba.europa.eu/documents/10180/1770344/EBA-Rec-2017-02+%28Recommendation+on+coverage+of+entities+in+group+recovery+plans%29.pdf/1fb547a6-2bbc-4487-9cc7-79a5318bfde2>

simplified obligations for recovery and resolution planning to institutions under their jurisdictions, provided that the institutions meet eligibility criteria set out in the BRRD. The EBA has been mandated to further specify these eligibility criteria and increase the convergence of approaches used by authorities in determining which institutions can benefit from such reduced obligations in recovery and resolution planning (compared with the full requirements imposed by the BRRD, its implementing regulations and relevant EBA regulatory products).

83. In May 2017, the EBA published the Consultation Paper<sup>23</sup> on the Draft RTS on criteria for assessing institutions' eligibility for simplified obligations for recovery and resolution planning under Article 4(6) BRRD. These Draft RTS would replace the existing EBA Guidelines<sup>24</sup> issued on the same topic in 2015, and increase harmonisation among the EU authorities in assessing eligibility for simplified obligations. The Draft RTS propose a two-stage approach to eligibility assessment for simplified obligations:

- a. Stage 1 – selecting institutions which could potentially benefit from simplified obligations based on a number of quantitative criteria measured on the basis of a set of quantitative indicators and a predefined threshold (for credit institutions, these indicators are fully aligned with metrics used in other EBA guidelines on O-SIIs identification);
- b. Stage 2 – verifying, in a qualitative assessment, whether or not institutions selected as potentially eligible for simplified obligations in Stage 1 also meet the other eligibility criteria. In order to cater for specific cases, the draft RTS provide a comprehensive list of exclusions applicable to the Stage 1 quantitative assessment (namely for promotional banks and credit institutions that have been subject to an orderly winding-up process).

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<sup>23</sup> See: <http://www.eba.europa.eu/regulation-and-policy/recovery-and-resolution/regulatory-technical-standards-on-simplified-obligations>

<sup>24</sup> See: <http://www.eba.europa.eu/regulation-and-policy/recovery-and-resolution/guidelines-on-simplified-obligations>

## 4. Convergence in the application of supervisory measures

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**Despite the remaining methodological differences, compared with 2016 the EBA noted improvements and increasing consistency in actual P2Rs imposed by competent authorities based on SREP outcomes. This resulted in a narrowing of ranges across the authorities. There are, however, still notable differences across the authorities, which are explained by the different methodologies used, differences in the risk taxonomies and also the use of P2R for macroprudential purposes.**

**Limited experience of P2G and the current lack of a common framework make it difficult to analyse the first wave of using P2G. Nonetheless, the majority of the competent authorities are setting P2G, albeit with divergences in approach, and the convergence should increase as the authorities start implementing the common framework for setting P2G that will be introduced in the revised SREP Guidelines.**

### 4.1 Analysis of aggregate P2R

84. As outlined in Section 2, convergence in the application of SREP methodologies across Member States and consistent application of supervisory measures across the EU is essential to ensure the consistency of supervisory outcomes and a level playing field, and is a key priority for the EBA.
85. As part of this work on the monitoring and assessment of supervisory convergence, in addition to the review of methodologies and practices employed by the competent authorities (discussed in Section 2), the EBA analyses supervisory measures applied by the authorities, in particular P2R applied across Member States following the SREP process. In 2016, this analysis was based on joint decisions for the largest cross-border groups and their subsidiaries. For the 2017 convergence assessment, a deeper and broader analysis of both P2R and P2G has been conducted, covering a larger sample of 17 authorities<sup>25</sup> and 194 institutions<sup>26</sup>.
86. Overall, material progress has been achieved in the application of P2R compared with 2016, and the EBA sees greater consistency in the ranges of P2R across the authorities. Nevertheless, challenges in the convergence of P2R remain:

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<sup>25</sup> The 17 competent authorities in the sample are those of BG, CZ, DE, DK, EE, FR, HR, HU, IE, LU, NO, PL, PT, RO, SE, SSM and UK. Not all EU competent authorities are included, as the sample of the 194 reporting banks implies that for some of the countries all the EBA reporting banks are under SSM supervision. Further, two countries did not submit any data.

<sup>26</sup> Data were requested for 194 institutions from the list of EBA reporting institutions. For some institutions, data were not submitted, but some additional banks have been reported on a voluntary basis by other competent authorities. Therefore, a maximum of 190 institutions was used for the data analysis, with some of the charts in this section based on fewer institutions, since voluntary submissions have been provided only for specific data points.

- a. In some cases, there are legal challenges for certain competent authorities in whose jurisdictions P2R continues to be a non-legally binding measure with which institutions are expected to comply.
  - b. Some authorities chose not to apply P2R as an institution-specific measure at all, instead relying on macroprudential capital measures (recommendations, or use of the CRD combined buffer requirements).
87. Furthermore, substantial improvements were observed as regards the interaction between P2R and the CRD combined buffer. In 2016, the EBA observed the inclusion of the capital conservation buffer in the institution-specific capital requirements for some competent authorities. This is no longer the case for the 2016 SREP decisions where more clarity was provided to institutions on the usability of buffers and P2R.
88. Nonetheless, like the previous year, the ranges of P2R applied in 2016 still vary across jurisdictions, sometimes substantially, while in some cases, for instance, the use of P2R for macroprudential purposes still continues. This is one of the reasons behind the differences observed in P2R levels across jurisdictions, a result which could have a substantial impact on the Single Market (see also Figure 4).
89. Because different samples were used, no direct comparison can be made between the P2R ranges applied in 2015 and 2016. However, Figures 4 and 5 show that the general picture of dispersion in terms of the size of P2R applied remains.

Figure 4. Ranges of P2R applied in 2016

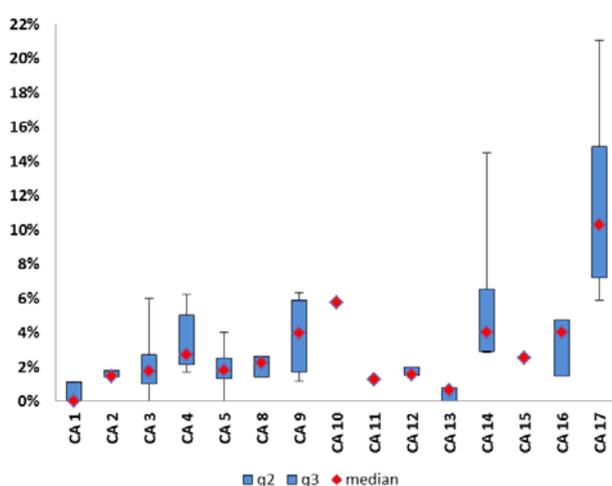
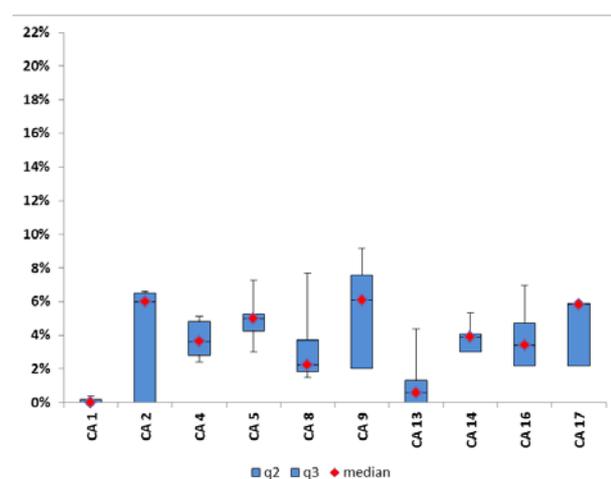


Figure 5. Ranges of P2R applied in 2015

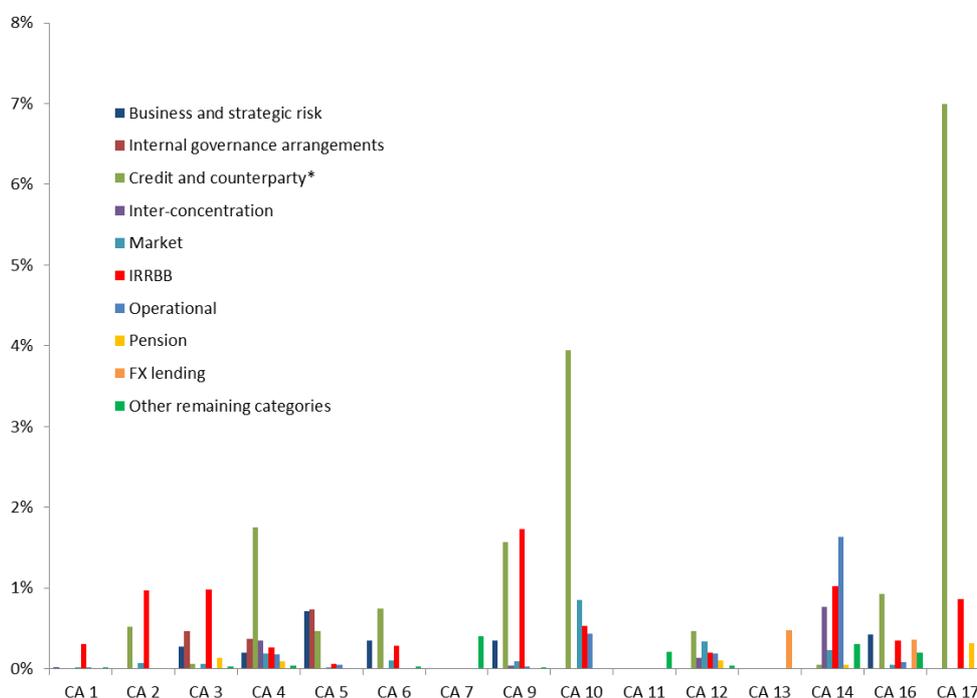


90. In some jurisdictions, P2R continue to be determined in a holistic way, with the decomposition of capital requirements into individual risk categories taking place only ex post. In particular, in

the context of cross-border groups and supervisory colleges, the lack of a transparent decomposition of capital add-ons at group level does not facilitate risk-by-risk discussion in the supervisory colleges and does not promote consistency and reconciliation of decisions for consolidated and entity-level capital requirements.

91. Another observation, from the most recent data analysis of capital requirements set in 2016, has been the use of different definitions of risk categories by the competent authorities when determining risk-by-risk capital add-ons. In total, 47 different risk categories were provided by the 17 competent authorities in the sample. These 47 risk categories can be broadly mapped into 9 major risk categories and a miscellaneous category (see Figure 6).

Figure 6. P2R across risk categories and competent authorities (averages by main risk categories)<sup>27</sup>



\*Includes risk weight floors, concentration risk, risk underestimation and others.

Note: For the chart, 5 of the 14 major risk categories have been further combined into 'Other remaining categories' for simplicity.

92. This heterogeneity observed in the mapping and identification of the different risk types emphasises the need for a common risk taxonomy to be used by supervisors across the EU. A common risk taxonomy could greatly improve convergence in the application of capital requirements across jurisdictions (see also Section 6.1.2).

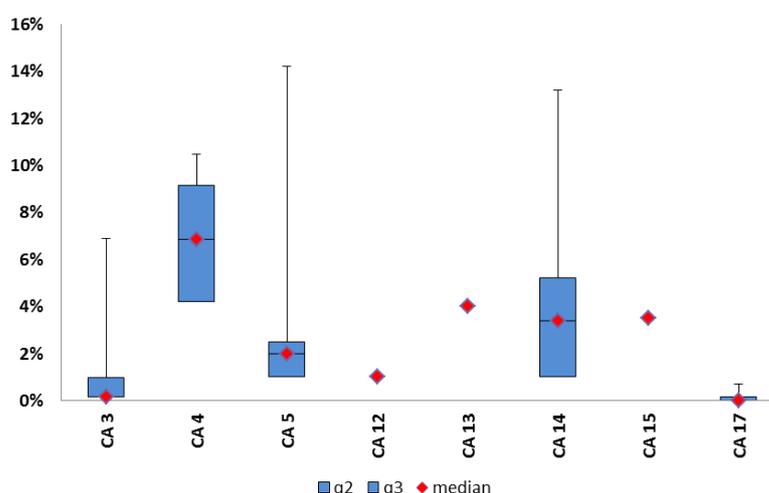
93. Furthermore, the (average) sizes of P2R used within the same risk category vary widely across the competent authorities (see Figure 6). Credit, market and IRRBB risk are the risk categories for which P2R are applied across most competent authorities.

<sup>27</sup> For the purpose of this chart, the 14 risk categories have been further reduced to 9 risk categories and 'Other remaining categories', which includes funding risk, group risk, risk of excessive leverage, model risk and systemic risk.

## 4.2 Analysis of aggregate P2G

94. The concept of P2G, as a non-binding capital expectation on top of OCR, addressing supervisory concerns over institutions' ability to meet capital requirements in stressed conditions identified on the basis of quantitative results of supervisory stress tests, was developed in 2016 and more technical details have already been introduced as part of the EBA Pillar 2 Roadmap.
95. Most of the competent authorities applied P2G for the first time in 2016. Lack of experience and absence of a common framework (the EBA is addressing P2G in the revisions to the SREP Guidelines – see Section 6.1.1) negatively affect convergence in this area. Only 5 out of the 17 competent authorities in the sample have applied P2G based on quantitative stress test results. A total of nine competent authorities have not applied P2G at all in 2016, and in three instances P2G has been applied based on factors other than the quantitative stress test results. This resulted in differences in the overall capital demand for banks across jurisdictions, with various sizes of P2G across jurisdictions and different dispersion of P2G within countries (see also Figure 7).

Figure 7. P2G as communicated (across those jurisdictions that applied P2G in 2016)



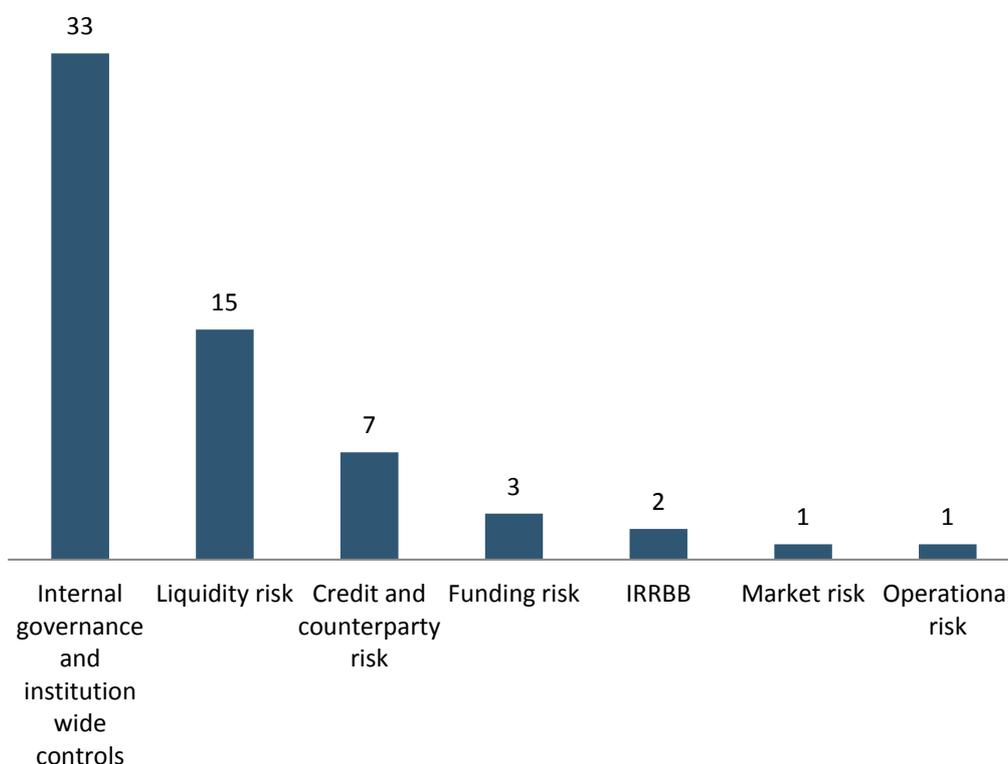
96. In addition to the differences observed in the size of P2G, the approaches to determining the final P2G amount also still vary substantially. Differences in the methodologies for the determination of P2G were observed in, inter alia, (1) the calculation of the maximum stress impact, (2) the amounts of adjustments applied and (3) the different elements of the CRD combined capital buffer ultimately used for offsetting purposes.

97. With respect to the relation between P2R and P2G, the EBA did not observe any specific trend in the relative sizes of P2R and P2G applied across competent authorities. Some competent authorities applied relatively high P2R coupled with relatively low P2G or vice versa, whereas other competent authorities set P2R and P2G at comparable levels.

### 4.3 Application of other supervisory measures by institutions covered

98. In total, 62 supervisory measures (other than P2R or P2G discussed above) have been applied by the competent authorities as the outcomes of SREP assessments in 2016 across the 20 closely monitored banking groups. Most of these measures (33) were in the area of internal governance and institution-wide controls, followed by liquidity risk, where a total of 13 other measures were counted (see Figure 8).

**Figure 8. Number of ‘other’ supervisory measures applied in 2016 based on SREP outcomes by risk category across the 20 closely monitored banking groups**



99. Within internal governance and institution-wide controls, more than half of the measures applied were related to improvements requested on ICAAP and ILAAP processes and models. Other measures applied include requirements for amending risk policies or how these are developed and implemented across the institution; measures to strengthen governance and control arrangements or to reduce the risk inherent in products, systems and operations;

changes to the organisational or functional structure of governance arrangements, including reporting lines; changes to the governance arrangements for setting risk appetite; and changes to the overall governance arrangement and risk management framework in general.

100. With regard to liquidity risk, in many cases in 2016 competent authorities required institutions to address deficiencies identified with regard to the institution's ability to identify, measure, monitor and control liquidity risk. One third of the cases requested more frequent reporting on specific liquidity indicators, while the remainder included restrictions on survival horizons to be applied, requests to enhance stress-testing capabilities and enhanced reporting to institutions' management.
101. Supervisory measures in the area of credit and counterparty risk were mainly related to generally reducing inherent risk or strengthening management and control frameworks, while there were two cases requiring specific floors being applied to internal risk parameters and enhanced collateral management.
102. With respect to funding risk, all supervisory measures were related to the reduction of concentration risk in banks' funding models. For IRRBB, market and operational risk, other supervisory measures were related to requesting an improvement in institutions' ability to identify, monitor and control these risks.

## 5. Convergence in the functioning of colleges of supervisors

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**Continuous improvement in the functioning of college of supervisors is illustrated in this report, which demonstrates the progress that has been made over time and the important link between colleges of supervisors of cross-border banking groups and supervisory convergence across the Single Market.**

### 5.1 Key conclusions regarding functioning of colleges in 2016

103. Within its mandate of facilitating supervisory cooperation and convergence between the competent authorities, the EBA monitors the functioning of supervisory colleges and participates in their activities in a proportionate manner. To improve the quality of monitoring, colleges are clustered into two groups: (1) closely monitored colleges and (2) colleges monitored on a thematic or selected basis. While for the first group the EBA closely follows the entire spectrum of college activities, for the latter the EBA's interaction is mainly limited to selected/specific activities and supplemented with regular thematic communication.

104. The EBA staff completed its annual assessment of closely monitored colleges again in 2016. It assessed three main elements of the colleges' work: (1) frequency and quality of interactions, (2) key deliverables and (3) responsiveness to the EBA's observations. Each assessment category was then scored against a three-level scoring system of 'good', 'satisfactory' and 'improvement needed', with the results noted on the scorecard for each individual college. This assessment and the scorecards have been shared with the colleges, with two aims: (1) to provide integrated feedback to consolidating supervisors and host competent authorities on a college-specific basis, by acknowledging achievements and identifying areas for further improvement; and (2) to inform BoS members about the performance of individual colleges under their remit and to share key conclusions on all 20 closely monitored colleges.

105. The EBA report<sup>28</sup> on the functioning of supervisory colleges in 2016 (Colleges Report) relied on the consolidated results of the individual college assessments as well as on the EBA staff observations gained through their participation in colleges of supervisors. These observations remain broadly valid for 2017.

106. In the 2016 Colleges Report, the EBA concluded that, overall, the level and quality of engagements in supervisory colleges had further improved in the course of 2016 compared with 2015, especially in the following respects:

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<sup>28</sup> See:

<https://www.eba.europa.eu/documents/10180/1720738/EBA+Report+on+the+functioning+of+supervisory+colleges+in+2016.pdf/283f550a-1a1d-4b7a-abce-66e8c9b445fb>

- a. On an annual basis, the EBA communicates to closely monitored colleges the expected level of college interaction in order to promote efficient and fluent interaction between competent authorities. In 2016, 90% of these colleges exceeded the EBA's expectations on the intensity of college interaction, compared with 74% in the previous year.
- b. In all of the closely monitored colleges, the quality and depth of discussions further improved in 2016 compared with 2015. College meetings benefited from a greater number of multilateral interactions, in-depth conversations and a certain degree of mutual challenging. On the other hand, some areas require further attention, including the timely circulation of meeting documents and the preparation of minutes.
- c. EBA staff observed that the group risk assessment reports (one of the key deliverables of the college) provided a good overview of risk profiles, with all material risks being captured and a sufficient level of detail included. However, EBA staff identified that one of the risk elements that should be further developed and properly reflected in the risk assessments is the business model analysis.
- d. The EBA pays particular attention to colleges' compliance with the applicable regulatory requirements, in particular in the joint decision process on the institution-specific prudential requirements. Although all colleges used the mandatory templates for the group and individual risk assessments<sup>29</sup>, there were still colleges that did not fully complete all parts of the mandatory annexes, mainly those parts that cover the breakdown of capital requirements by individual risks. This not only equated to non-compliance with the legally binding technical standards, but also meant that the link between the outcome of the risk assessment and the reasoning for setting P2R in the joint decision was not properly substantiated. The EBA stressed to the colleges in question the importance of completing all mandatory annexes, as the sharing of the risk-by-risk decomposition of capital requirements can be seen a precondition of ensuring comparable supervisory practices throughout the SREP process.
- e. In almost all of the closely monitored colleges, a dialogue between the consolidating supervisor and the relevant competent authorities was organised in a multilateral setting to discuss and agree upon the proposed capital and liquidity requirements. While the draft joint decision documents were circulated in all colleges prior to commencing a supervisory dialogue, material information on the proposed supervisory measures was omitted from many documents. The EBA expects this practice to be improved in the future.
- f. Overall, the final joint decision documents on capital and liquidity of the closely monitored colleges were well reasoned and contained information on and/or references to the conclusions of the SREP, as reflected in the group risk/liquidity risk assessment reports. The EBA, however, notes that the liquidity joint decisions were of a lower quality than the

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<sup>29</sup> As per the technical standards for the joint decision process on institution-specific prudential requirements (Commission Implementing Regulation (EU) No 710/2014). See: <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014R0710&from=EN>

capital joint decisions, mainly because of (1) their less granular reasoning, particularly for the subsidiaries; (2) their lack of consistency in the structure of the document for the subsidiaries; or (3) their weak connection between the reasoning in the liquidity joint decision document and the group liquidity risk assessment.

107. To better assess the degree of convergence in the functioning of the colleges monitored on a thematic or selected basis, in 2016 the EBA introduced self-assessment questionnaires for such colleges, allowing EBA to collect substantial information on the activity of this group of colleges for the first time. Based on the analysis of the self-assessment questionnaires, the EBA concluded that, while physical meetings have not yet been fully introduced into the interactions of this group of colleges, as almost one third have held no physical meetings in 2016, the majority of them completed the joint decision process and reached the final joint decisions on institution-specific prudential requirements within the legally applicable timeframes. Most importantly, no disagreements between college members on the capital and liquidity joint decisions were indicated in the self-assessment templates. However, in cases when the EBA staff became aware of any potential issues, they proactively liaised with the consolidating supervisor and participated in college meetings.

## 5.2 The EBA's role in the identification and promotion of topics for supervisory attention in 2018

108. On an annual basis, the EBA establishes an action plan for supervisory colleges, which provides competent authorities responsible for supervising cross-border banking groups with a set of objectives and deliverables that also includes key topics referred to as heightened supervisory attention. The EBA identifies such topics based on (1) the EBA's risk analysis work, and findings from its bi-annual risk assessments that identify risks that pose major threats to the EU cross-border institutions and, thus, represent significant concerns for the EU supervisory authorities; (2) monitoring of new regulatory developments; and (3) findings from the monitoring of supervisory colleges in the course of the previous year (see Figure 9 for the key topics for supervisory attention in 2018).

Figure 9. Key topics for supervisory attention as identified in the 2018 Colleges Action Plan



109. Competent authorities supervising cross-border banking groups are requested to pay particular attention to these topics in 2018 and organise relevant discussions within the supervisory colleges' framework. By communicating these key topics on a yearly basis, the EBA ensures that the risks that are identified at macro level are cascaded through college structures to the micro level in a consistent manner across all colleges and that appropriate attention is dedicated to these areas of concern. With regard to closely monitored colleges, the EBA follows up on how far these colleges incorporated the topics into their yearly work and provides them with feedback accordingly as part of its college-monitoring activities.

## 6. EBA policy work supporting supervisory convergence

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**In 2017-2018, the EBA will carry out a major update of its Pillar 2 related products in accordance with its Pillar 2 Roadmap, with public consultations taking place in 2018 and application set for the beginning of 2019. The implementation of these revised Guidelines would further benefit the convergence of supervisory practices.**

### 6.1 Supervisory review and evaluation process

110. Throughout 2017, the EBA has continued its work on providing a solid legislative basis and policy background to further strengthen supervisory convergence. This year, the EBA has finalised a number of regulatory products on SREP and wider Pillar 2 areas addressed to both the institutions and the competent authorities. Additional regulatory products are currently in progress, aiming to further promote supervisory convergence across the EU. This section provides a brief overview of the major policy development projects and publications aimed at promoting convergence of supervisory practices amongst the competent authorities, which would provide a reference for future convergence monitoring and assessment activities.

111. It is important to note that the EBA's policy development work in the field of supervisory practices is mostly driven by the EBA's addressing, on its own initiative, supervisory needs and areas where further convergence is desirable, and also its reflection on the findings from the ongoing monitoring and assessment of convergence.

#### 6.1.1 Revision of the SREP Guidelines and Pillar 2 Roadmap

112. The comprehensive common EU SREP framework established by the SREP Guidelines in 2014, in the EBA's view, remains robust and serves well the purpose of ensuring convergence of supervisory practices. However, in the light of the recent developments in the EU and international fora, as well as based on EBA findings from the ongoing monitoring and assessment of convergence of supervisory practices, some changes are needed to reinforce the framework.

113. In particular, recent external developments require a comprehensive and multistage approach to the revision, and the update of several EBA Pillar 2 related policy documents. These developments include the revision of the Basel framework for IRRBB; the EBA's work on introducing P2G; progress in the fields of stress testing and supervisory stress testing; and the planned revision of the Pillar 1 framework in the CRR/CRD.

114. To this end, the EBA has defined a Roadmap<sup>30</sup> explaining the scope of the multistage revision of SREP Guidelines, IRRBB Guidelines and Stress Testing Guidelines. In accordance with this Roadmap, in 2017-2018 the EBA revised the SREP Guidelines, updated the IRRBB Guidelines and finalised the Stress Testing Guidelines<sup>31</sup>. The revised package of these Guidelines will be planned for practical application in 2019. Later on, the EBA will continue working on Pillar 2 related topics pending the final agreement on CRR/CRD revisions and will develop a series of IRRBB related technical standards (see section 6.1.4).

115. In relation to the update of the SREP Guidelines, the 2017-2018 revision includes (1) introducing P2G and integrating supervisory stress testing; (2) clarifying certain aspects of the scoring framework and better explaining interaction between elements of SREP; (3) improving the articulation of TSCR and OCR; (4) aligning the assessment of IRRBB with the revision of the IRRBB Guidelines; (5) reinforcing supervisory assessment of banks' stress testing and supervisory stress testing; and (6) updating and ensuring consistency of the assessment of internal governance and institutions-wide controls with the revised EBA Guidelines on internal governance.

116. Moreover, the forthcoming CRD V, currently in progress with the European Commission, is also aiming to further limit the diverse interpretations of additional capital requirements, which may have resulted in different capital requirements on individual EU institutions, and to explicitly allow competent authorities to communicate to institutions what own funds in excess of the OCR they are expected to have.

### 6.1.2 Supervisory risk taxonomy and supervisory benchmarks

117. The outcomes of the EBA's quantitative convergence analysis of P2R, as also mentioned in Section 4.1, further support the need for a common risk taxonomy across the competent authorities as a way to enhance supervisory convergence. While the analysis in Section 4.1 showed that P2R applied across most competent authorities on credit, market and IRRBB risk categories, divergence still persists on the type and categorisation of risks employed by the competent authorities as well as on the definition of risks. Such similar results to last year's stocktake of supervisory practices<sup>32</sup> highlight the development of a common risk taxonomy across the EU.

118. To this end, in 2017 the EBA has developed a supervisory risk taxonomy, which currently goes through a testing period, covering all risk categories and their subcategories, along with definitions and mapping to regulatory reporting. The aim of this risk taxonomy is to introduce a common risk language and strengthen convergence of supervisory practices for SREP, ultimately enhancing the level playing field in the Single Market.

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<sup>30</sup> See: <https://www.eba.europa.eu/documents/10180/1814098/EBA+Pillar+2+roadmap.pdf>

<sup>31</sup> See: <https://www.eba.europa.eu/-/eba-launches-consultations-to-strengthen-the-pillar-2-framework>

<sup>32</sup> <https://www.eba.europa.eu/documents/10180/1360107/EBA+report+on+the+convergence+of+supervisory+practices>

119. The EBA continued mapping existing supervisory benchmarks that competent authorities use to help them challenge banks' ICAAP estimates and quantify P2R in the context of SREP. Specifically, analysis has been conducted on the supervisory benchmarks developed for credit concentration risk. This has been focused on the calibration of the benchmarks, in particular on the relation between benchmarks and concentration levels. Going forward, this work will align with the timeline of the BCBS's work plan on concentration risk, which is focused on sharing different supervisory practices (over the course of 2017/2018).

### 6.1.3 Guidelines on ICAAP and ILAAP information collected for SREP purposes

120. In November 2016, the EBA published its final Guidelines<sup>33</sup> on ICAAP and ILAAP information collected for SREP purposes, which aim to facilitate a consistent approach to the supervisory assessment of ICAAP and ILAAP frameworks across the EU as part of the SREP.

121. These Guidelines specify what information regarding ICAAP and ILAAP competent authorities should collect from institutions in order to perform their assessments of ICAAP and ILAAP frameworks and the reliability of ICAAP and ILAAP capital and liquidity estimates in a consistent manner following the criteria specified in the SREP Guidelines. In addition to specifying information items, these Guidelines also set general criteria for competent authorities to organise collection of ICAAP and ILAAP information from institutions and use such information for the purposes of their assessments of other SREP elements, taking into account the principle of proportionality in relation to the frequency, reference and remittance dates, scope, and level of detail of the information collected.

### 6.1.4 Update of IRRBB Guidelines

122. In the wider revision of the EBA Pillar 2 framework in 2017-2018 explained in the EBA Pillar 2 Roadmap, the IRRBB Guidelines are revised to reflect the update of the BCBS IRRBB standards, which is due for implementation by 2018. The implementation of the new BCBS standards at the EU level will be phased in in two parts, and will be effected through (1) an update of the EBA IRRBB Guidelines as well as (2) a number of technical standards that the revised CRR/CRD is expected to mandate the EBA to produce.

123. This revision of the IRRBB Guidelines includes (1) the clarification of definitions and expanding the scope of the Guidelines to include credit spread risk in the banking book, (2) the update of parameters and assumptions of the supervisory standard shock, (3) the update of standardised interest rate shock scenarios and (4) an update of requirements on internal governance arrangements. The revision will aim to start the implementation of the revised BCBS standards in Europe and, thus, bridge the time gap between the implementation of the BCBS standards and technical standards to be introduced following the revision of the CRR/CRD framework.

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<sup>33</sup> See: <http://www.eba.europa.eu/regulation-and-policy/supervisory-review-and-evaluation-srep-and-pillar-2/guidelines-on-icaap-and-ilaap-information>

### 6.1.5 Progress on Guidelines on institutions' stress testing

124. In accordance with its Pillar 2 Roadmap, the EBA also finalised the revision of its Guidelines on institutions' stress testing. These draft Guidelines were already published for public consultation in 2016 and were published for a second public consultation in 2017, aligned with the timeline of the SREP and IRRBB Guidelines update.

125. A second consultation followed because of the structural changes to these Guidelines and the additional details that they provide on specific topics such as reverse stress testing, links between solvency and liquidity stress testing, and links between stress testing and recovery planning. All aspects related to the supervisory assessment of institutions' own stress testing, supervisory stress testing and the use of quantitative outcomes of stress testing will be incorporated into the revised SREP Guidelines. This leaves the Stress Testing Guidelines to focus on setting requirements for institutions.

### 6.1.6 Guidelines on ICT risk assessment under SREP

126. In view of the growing importance and increasing complexity of information and communication technology (ICT) risk within the banking industry and in individual institutions, the EBA has developed Guidelines on ICT risk assessment under SREP<sup>34</sup> to assist the competent authorities in their assessment of ICT risk as part of the SREP. Acknowledging the growing importance of ICT systems and hence the increasing potential prudential impact from their failures on an institution and on the sector as a whole (in particular due to cross-border interlinkages between institutions), and taking into account the technical specificities of ICT risk assessments and the objective of increasing convergence of supervisory practices in ICT risk assessments within the EEA, these Guidelines provide guidance to supervisors on assessing ICT risk in institutions.

### 6.1.7 Recommendations on cloud outsourcing

127. Through interactions with several stakeholders, the EBA identified the need for developing specific guidance for outsourcing to cloud service providers. A high level of uncertainty appears to exist in relation to the supervisory expectations that apply to outsourcing to cloud service providers, and such uncertainty forms a barrier to institutions using the cloud services.

128. To this end, the EBA has developed draft Recommendations on outsourcing to cloud service providers<sup>35</sup> that specify the supervisory requirements and processes that apply when institutions are outsourcing to cloud service providers. Where the EBA Guidelines on outsourcing<sup>36</sup> remain applicable for general outsourcing by institutions, these Recommendations provide additional guidance for the specific context of institutions that

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<sup>34</sup> See: <http://www.eba.europa.eu/regulation-and-policy/supervisory-review-and-evaluation-srep-and-pillar-2/guidelines-on-ict-risk-assessment-under-the-srep>

<sup>35</sup> See: <http://www.eba.europa.eu/regulation-and-policy/internal-governance/recommendations-on-outsourcing-to-cloud-service-providers>

<sup>36</sup> CEBS Guidelines on outsourcing of 14 December 2006, available online: <https://www.eba.europa.eu/documents/10180/104404/GL02OutsourcingGuidelines.pdf.pdf>

outsource to cloud service providers. The Recommendations will be finalised in the first half of 2018.

## 6.2 Supervision of branches

129. The EBA has developed own initiative Guidelines on the supervision of significant branches<sup>37</sup>. They aim to facilitate cooperation and coordination between competent authorities in supervising the largest systemically important branches.

130. These Guidelines provide a framework for the identification of such systemically important and group-relevant branches (so called ‘significant-plus’ branches), a subset of branches designated as ‘significant’ in accordance with Article 51 of the CRD, and outlines a coordinated approach to their supervision, facilitated through the framework of colleges of supervisors. In particular, within the existing CRR/CRD legal framework for the supervision of branches, the Guidelines aim to enhance cooperation and coordination between the authorities in performing risk assessments, assessing of recovery plans, exchanging supervisory intelligence and information, planning supervisory activities, carrying out on-the-spot checks and inspections, applying supervisory and precautionary measures, and allocating tasks between authorities.

## 6.3 Internal governance

131. In December 2015, the EBA published its Opinion<sup>38</sup> on the application of the principle of proportionality to the remuneration provisions in CRD (EBA/OP/2015/25). It recommended introducing possible exemptions from some of the remuneration principles set out in Article 94 of the CRD. In November 2016, the EBA published a report<sup>39</sup> setting out the EBA’s response to a letter from the European Commission, dated 21 April 2016, requesting further information with regard to the EBA Opinion<sup>40</sup> on the application of the principle of proportionality to the remuneration provisions in Directive 2013/36/EU (EBA/OP/2015/25).

132. The report provides an overview of the applicable framework regarding the principle of proportionality in each Member State and analyses the number of institutions and staff currently benefiting from waivers from the application of the requirements of Article 94(1)

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<sup>37</sup> See: <http://www.eba.europa.eu/regulation-and-policy/passporting-and-supervision-of-branches/guidelines-on-supervision-of-significant-branches>

<sup>38</sup> See: <https://www.eba.europa.eu/documents/10180/983359/EBA-Op-2015-25+Opinion+on+the+Application+of+Proportionality.pdf>

<sup>39</sup> See: <https://www.eba.europa.eu/documents/10180/1667706/EBA+Opinion+on+the+application+of+the+principle+of+proportionality+to+the+remuneration+provisions+in+Dir+2013+36+EU+%28EBA-2016-Op-20%29.pdf>

<sup>40</sup> See: <https://www.eba.europa.eu/documents/10180/983359/EBA-Op-2015-25+Opinion+on+the+Application+of+Proportionality.pdf>

points (l) and (m) and the second subparagraph in point (o) of the CRD, and also with a breakdown by Member State. In addition, the report provides information, for each Member State, about the institutions and staff who could benefit from waivers from the application of the requirements of Article 94(1) points (l) and (m) and the second subparagraph in point (o) CRD if the amendment proposed by EBA in its Opinion were to be adopted. Finally, the report describes the current national implementation of the CRD regarding the possibility of listed institutions using share-linked instruments: most Member States already allow this possibility in their national law.

133. The report showed that, within the EU, two thirds of credit institutions and ca 60% of their identified staff benefit from waivers. However, their market share, ca 18%, is not as high as the number of institutions would suggest. There are vast differences between these figures across Member States. These divergences are mainly a result of differences in the thresholds being applied, levels of variable remuneration being paid and structural differences in the banking sectors of Member States.

134. Estimates for thresholds of EUR 1.5 bn, EUR 5 bn and EUR 10 bn for potential waivers have been calculated. The percentages differ between Member States but at these thresholds, based on EEA or EU27 (without the UK) figures, in total around 75% to 90% of institutions, 35% to 60% of the identified staff and 3% to 15% of the market share would be able to benefit from waivers. This would be in addition to staff who could benefit from waivers based on low levels of remuneration. However, results differ significantly between Member States depending on the structure and size of the financial market.

### 6.3.1 Revision of the Guidelines on internal governance and Guidelines on ‘fit and proper’

135. In October 2016, the EBA launched a public consultation on its revised 2010 Guidelines on internal governance and, together with ESMA, the draft joint Guidelines on the assessment of the suitability of members of the management body and key function holders (‘fit and proper’).

136. The first of those two sets of Guidelines aim to further harmonise institutions' internal governance arrangements, processes and mechanisms across the EU, in line with the new requirements in this area introduced in the CRD taking the proportionality principle into account. Those Guidelines put more emphasis on the duties and responsibilities of the management body in its supervisory function in risk oversight, including the role of its committees. They aim to improve the status of the risk management function, enhancing the information flow between the risk management function and the management body and ensuring effective monitoring of risk governance by supervisors. The ‘know your structure’ and complex structures sections have been strengthened to ensure that the management body is aware of the risks that can be triggered by complex and opaque structures and to improve transparency. The publication of the ‘Panama papers’ has given additional impetus to this. In addition, the framework for business conduct has been further developed and more emphasis is given to the establishment of a risk culture, a code of conduct and the management of conflicts of interest.

137. The Guidelines on ‘fit and proper’ aim to further improve and harmonise suitability assessments, including the assessment processes performed by competent authorities, within the EU financial sectors and so ensure sound governance arrangements in financial institutions. They give further guidance on the scope of assessments to be made, the assessment process for institutions and competent authorities, and related policies. The Guidelines lay down that the heads of internal control functions and the Chief Financial Officer, where they are not members of the management body, are always considered key function holders who are to be assessed by institutions.
138. As laid down in the CRD, the management body must collectively possess adequate knowledge, skills and experience to understand the institution’s activities, including the main risks. In this respect, the Guidelines provide a non-mandatory tool that should facilitate the assessment of collective suitability. The Guidelines also cover the requirement on time commitment and the limitation of directorships, the notion of adequate human and financial resources for induction and training, and the notion of diversity, which is to be taken into account when recruiting members of the management body.

## 6.4 Supervisory assessment of internal models

139. Following the mandates contained in the CRR/CRD, the EBA developed a number of technical standards regarding the broad scope of internal model approaches, which set the requirements to be complied with mainly by those institutions that are seeking approval of their internal model approaches for own funds requirements calculations. In addition, the EBA has been developing Guidelines on PD, LGD and defaulted asset estimation on its own initiative, and based on recommendations from its previous reports on the comparability and procyclicality of capital requirements. These reports confirmed that there were significant discrepancies in risk parameters and own funds requirements across institutions and jurisdictions that did not reflect differences in risk profiles but resulted from different underlying definitions and certain modelling choices.

### 6.4.1 Implementation of the regulatory review of internal models

140. During 2016, the EBA published a report<sup>41</sup> and an Opinion<sup>42</sup> on the implementation of the regulatory review of internal models. A discussion paper<sup>43</sup> (published in 2015) summarised several planned regulatory changes in the current IRB approach, which would contribute to the robustness of the current IRB approach and provide a higher degree of comparability across EU banks. The report summarised the industry feedback from the public consultation on the EBA

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<sup>41</sup> See:

<http://www.eba.europa.eu/documents/10180/1360107/EBA+Report+on+the+regulatory+review+of+the+IRB+Approach.pdf>

<sup>42</sup> See: <http://www.eba.europa.eu/documents/10180/1359456/EBA-Op-2016-01+Opinion+on+IRB+implementation.pdf>

<sup>43</sup> See: <http://www.eba.europa.eu/regulation-and-policy/credit-risk/discussion-paper-on-the-future-of-the-irb-approach>

discussion paper on the future of the IRB approach. For the purpose of providing guidance and clarity to both competent authorities and institutions, the Opinion presented the general principles and timelines for the implementation of the regulatory review of the IRB approach, which includes the harmonisation of definitions and supervisory practices in the definition of default, the estimation of risk parameters and treatment of defaulted assets, credit risk mitigation techniques and disclosure.

141. The Opinion sets out an overall timeline for implementation in four phases, which requires all changes related to the regulatory review to be finalised by the end of 2020. At the same time, the Opinion notes that the necessary bank-specific changes are best determined in consultation with the relevant competent authority.

142. The RTS on assessment methodology is the main building block of the first phase (see Section 6.4.2 below), whereas the second phase aims to harmonise the definition of default (see Section 6.4.3 below). The third phase is focused on GLs on risk parameter estimates (PD, LGD and ELBE) as well as the RTS under Articles 181(3)(a) and 182(4)(a) of the CRR on the nature, severity and duration of economic downturn for LGD and CCF estimation (see Section 6.4.4 below). The fourth phase should bring further harmonisation in the area of credit risk mitigation. Both the third and fourth phases are planned to be finalised in 2017.

#### 6.4.2 Assessment methodology for IRB models

143. In the application of the mandates specified in Articles 144(2), 312(4)(a) and 363(4)(b) of the CRR, the EBA has developed the draft RTS to specify the methodology that competent authorities must follow in assessing the compliance of institutions with the requirements to use internal model approaches.

144. The RTS on the IRB assessment methodology<sup>44</sup> are addressed to competent authorities and will affect supervisory practices and criteria used by competent authorities in assessing an institution's compliance with minimum IRB requirements. It is expected that these draft RTS will significantly increase harmonisation of the supervisory assessment methodology across all Member States, thereby rectifying the issues identified in the assessment of comparability of the IRB models<sup>45</sup>.

#### 6.4.3 Definition of default

145. The EBA developed an RTS and Guidelines which will harmonise the application of the identification of default on credit obligations past due. In applying the mandates specified in Article 178 of the CRR, the EBA developed the RTS to specify the conditions under which competent authorities shall set the threshold for assessing the materiality of a credit obligation

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<sup>44</sup> See: <https://www.eba.europa.eu/documents/10180/891573/EBA-CP-2014-36+%28CP+on+RTS+on+Assessment+Methodology+for+IRB+Approach%29.pdf>

<sup>45</sup> The consultation paper on RTS on the assessment methodology for the IRB Approach was already published in 2014. The RTS were finalised and submitted to the European Commission in July 2016.

past due. The threshold must reflect a level of risk that the competent authority considers reasonable.

146. The institutions currently use a wide range of practices with regard to materiality thresholds, in part because competent authorities set different requirements in this regard. These RTS aim to address this divergence in application. This harmonisation is necessary in order to ensure a consistent use of the materiality threshold and will help reduce the burden of compliance for cross-border groups.

147. These RTS are closely linked to the Guidelines on the application of default of an obligor, which is specified in Article 178 of the CRR. It includes, among other considerations, the days past due criterion for default identification, indications of unlikelihood to pay, conditions for the return to non-defaulted status and treatment of the definition of default in external data. In these respects, various different approaches have been adopted across institutions and jurisdictions. As a consequence, a wide range of practices has been observed. It is expected that the harmonisation of practices will not only increase comparability of risk parameters and own funds requirements but also reduce the burden for cross-border institutions of complying with different requirements in different Member States.

#### 6.4.4 The GL on PD, LGD and defaulted assets

148. In November 2016, the EBA published its consultation<sup>46</sup> on its draft Guidelines on the estimation of risk parameters for non-defaulted exposures, namely of the probability of default (PD) and the loss given default (LGD), and on the treatment of defaulted assets.

149. These Guidelines are focused on the definitions and modelling techniques used in the estimation of risk parameters for both non-defaulted and defaulted exposures, whereas other regulatory products developed in the review process will clarify other aspects related to the application of the IRB approach. The EBA considers these clarifications and harmonisation necessary in order to achieve comparability of risk parameters estimated on the basis of internal models and to restore trust in these models by market participants while at the same time preserving the risk sensitivity of capital requirements.

150. Complementing the package of the third phase of the internal model review are draft RTS specifying the nature, severity and duration of an economic downturn, according to which institutions shall estimate the downturn LGD and conversion factor. The EBA consulted on these RTS in March 2017. The GL on PD, LGD and defaulted exposures and a report on the IRB survey results are expected to be published by the end of 2017, and the RTS on downturn is expected to be finalised by the end of 2017.

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<sup>46</sup> See:

<https://www.eba.europa.eu/documents/10180/1659311/Consultation+Paper+on+Guidelines+on+PD+LGD+estimation+and+treatment+of+defaulted+assets+%28EBA-CP-2016-21%29.pdf>

151. It is expected that the changes resulting from these GL and these RTS will have a significant impact on the modelling practices in some institutions. Therefore, the EBA issued a qualitative survey at the end of 2016, in order to assess the impact of these GL and RTS, in terms of the expected materiality of modelling changes resulting from the GL, and taking into account that the overall impact of the policy decisions on the level of these risk parameters should be limited. In particular, this qualitative survey contains detailed questions about institutions' modelling practices, on topics that are directly addressed by or closely related to the GL (and draft RTS).

## 7. Training activities

**The EBA is also stepping up its activities in training supervisors by further expanding its residential offering and investing in online training facilities that would enable it to reach more line supervisors in the competent authorities.**

152. In its efforts to further promote supervisory convergence, the EBA continues to expand its training programme for supervisors. As in previous years, the training activities mostly focused on the implementation of new parts of the Single Rulebook addressed to the supervisors, and in particular on the implementation of the EBA Guidelines on common procedures and methodologies for the SREP and the assessment of recovery plans.

153. In 2016, the EBA organised 18 sectoral training events for competent and resolution authorities, one cross-sector event, jointly organised with EIOPA, and four online events. Eleven of them were held at the EBA and eight were locally run, off site, in Warsaw, Brussels, Prague, Dublin, Sarajevo and Vilnius, including a cross-sectoral training event on ‘Impact Assessment in Practice’ held in Frankfurt. Overall, the events offered were oversubscribed, in particular the online training. In 2016, the EBA continued to cooperate with its training partners from ESE<sup>47</sup> and for the first time organised a dedicated outreach training event under the auspices of the Memorandum of Cooperation with supervisory authorities in six South-Eastern European countries, establishing a framework for cooperation and information exchange<sup>48</sup> (see Table 2).

**Table 2. Overview of the training events the EBA provided to competent authorities in 2016**

	<b>Title</b>	<b>Date</b>	<b>Location</b>	<b>Attendees</b>
1	Joint Risk Assessment and Joint Decisions in Colleges (for staff of PRA, UK, only)	29 January	EBA, London	21
2	Common European SREP framework. EBA Guidelines on SREP	22-23 February	KNF, Warsaw	97
3	Online training module: Bank Recovery Planning	29 February-15 March	Online	27
4	Training on COREP and FINREP (SRB staff only)	15 March	SRB, Brussels	54
5	EBA-ESE seminar on Capital Markets – Innovative Products	7-8 April	CNB, Prague	40
6	Supervisory Colleges and Joint Decisions	12-13 April	EBA, London	24
7	Common European SREP framework. EBA Guidelines on SREP (CBI staff only)	21-22 April	CBI, Dublin	54
8	Joint EBA/ESE seminar on Stress Testing and Asset Quality Review	26-27 April	CNB, Prague	20

<sup>47</sup> ESE (European Supervisor Education Initiative) is an alliance of some EU central banks and supervisory authorities. Its members are Bank of Slovenia, Banque centrale du Luxembourg, Czech National Bank, De Nederlandsche Bank, Deutsche Bundesbank, German Federal Financial Supervisory Authority and Oesterreichische Nationalbank.

<sup>48</sup> See: <http://www.eba.europa.eu/-/eba-signs-memorandum-of-cooperation-with-south-eastern-european-supervisors>

9	Joint EBA/SRB training: Resolution Induction Training	26 May	EBA, London	98
10	Joint EBA/Basel FSI – Basel III and CRD IV/CRR – Latest Developments and Implementation Challenges	7-9 June 2016	EBA, London	37
11	Cross-sector seminar with EIOPA: Impact Assessment in Practice	9 June	EIOPA, Frankfurt am Main	30
12	Online training module: Supervisory Review and Evaluation Process (SREP)	13-17 June	Online	79
13	Valuation in Resolution	21 June	EBA, London	71
14	Online training module: Bank Recovery Plans 2	27 June-8 July	Online	48
15	IT Supervision – Cyber Security	1-2 September	EBA, London	60
16	Common European SREP framework and Supervisory assessment of recovery plans	22-23 September	Federal Banking Agency, Sarajevo	45
17	Operational Risk	29 September	EBA, London	33
18	Common European SREP framework. EBA Guidelines on SREP	5-6 October	LB, Vilnius	46
19	Workshop on the Role of Mediation in Colleges	19 October	EBA, London	10
20	ITS Data Analysis	15-16 November	EBA, London	74
21	Online training module: Supervisory Review and Evaluation Process (SREP) 2	28 November-9 December	Online	71
22	Introduction to Data Point Modelling and EBA Taxonomy	12-13 December	EBA, London	51
23	Supervisory Assessment of Recovery Plans	13-14 December	EBA, London	41
	<b>Total</b>			<b>1 131</b>

154. In 2016, the EBA continued to expand its online training offering, successfully running four different courses that reached 225 participants.

155. Going forward, the EBA will define its core curriculum for supervisors and gradually develop specific training programmes for all the items in the core curriculum. Three areas have been identified in which it will be crucial to establish common European training:

- a. assistance in the implementation of EBA policy products;
- b. key topics relevant to the regulatory landscape;
- c. key 'at risk' topics for supervisory attention.

156. The EBA also plans to continue offering its existing online training modules on SREP and bank recovery planning, further facilitating off-line training events and designing additional online training courses through its own online training platform.



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