



BANKING STAKEHOLDER GROUP

CONSULTATION ON EBA/CP/2014/14 ON
GUIDELINES FOR COMMON PROCEDURES AND METHODOLOGIES
FOR THE SUPERVISORY REVIEW AND EVALUATION PROCESS

General Comments and Replies to Questions

BY THE EBA BANKING STAKEHOLDER GROUP

London, October 18th, 2014

Foreword

The EBA Banking Stakeholder Group (“BSG”) welcomes the opportunity to comment on the Consultation Paper EBA/CP/2014/14 on “Guidelines for common procedures and methodologies for the supervisory review and evaluation process (SREP)”.

This response has been prepared on the basis of comments circulated and shared among the BSG members and the BSG’s Technical Working Group on Capital and Risk Analysis.

As in the past, the BSG supports an initiative that aims at harmonizing supervisory rules and practices across Europe, in order to ensure fair conditions of competition between institutions and more efficiency for cross-border groups. The BSG also expects these initiatives to facilitate data sharing between European supervisors and avoid reporting duplications for banks. However, the BSG identifies a number of issues which, unless properly addressed, could lead to unintended results.

This response outlines some general comments by the BSG.

General comments

This paper is important because it translates the EU CRR/CRD4 regulation into the EU supervision, and describing the new general framework in which supervisors will work. It has long been waited by banks which have been expecting a convergence of different practices in Europe. The BSG welcomes the enormous effort and work produced by the EBA team on these important matters.

However there are some key points that BSG wishes to emphasize. These have been discussed with the EBA during a meeting on Monday 6 October and this has proved to be useful and productive. We thank very much the EBA for having initiated this.

First of all, we would like to focus strongly on the importance of dialogue that currently exists between institutions and their supervisors under the SREP: this should continue.

There are specificities of business models and of national markets which need to be correctly understood and taken into account in order to achieve a fair and comprehensive SREP assessment of each institution.

And yet the proposed draft guidelines on the SREP are remarkably silent on this dialogue and on the procedures that should support it, with the exception of a brief reminder at paragraph 35 [“when planning SREP activities competent authorities should adhere to a minimum level of supervisory engagement (e.g. in the form of a

dialogue...”]. We understand from our meeting with the EBA on Monday 6 October that this is clearly not intended to be the case. It is our view that the EBA’s guidelines should be widely completed on this prime aspect of Pillar 2 and we thank EBA for the forthcoming clarification in the final paper.

Pillar 2 is a process banks should develop for assessing their overall capital adequacy in relation to their risk profile and strategy for maintaining their capital levels

The ICAAP and ILAAP should be tailored to each institution to appropriately reflect its capital and liquidity needs and should be grounded to the largest extent on internal estimations, methodologies and risk parameters, as appropriate.

To foster convergence in the fields of ICAAP / ILAAP, it would be advisable to complement the guidelines as follows :

- they should indicate the range of acceptable methodologies and specify that internal modeling and / or economic capital modelling can be used,
- there should be no automatic calculation : Pillar 2 is by no way a kind of super pillar 1 +,
- It should be clarified how the proportionality principle should apply to institutions of categories 1 to 4, as defined at paragraph 11.

Our meeting with the EBA has clarified that the starting point of the SREP is definitely the ICAAP. The ICAAP is part of the on-going holistic view of the bank (ICAAP, risks, benchmarks as defined below, peer reviews, business models and more importantly judgment...) which will form the final SREP decision framework. We understand the final paper will be supplemented by a paragraph on the overall articulation.

Internal capital

We welcome the efforts undertaken by EBA to reach the next level of harmonization within the supervisory review and evaluation process. Such a process of convergence should take into account the principles outlined in the CRDIV. ICAAP and SREP are two elements inextricably linked with each other, which jointly build the foundations for Pillar 2. According to Article 104 CRDIV, the competent supervisor must consider, before requesting any additional capital, the supervisory assessment and evaluation of the quantitative and qualitative aspects of the ICAAP according to Article 73 and the institutional specific requirements and processes according to Article 74.

The procedures for the ICAAP are outlined in Article 73 of CRDIV. Credit institutions are requested “ to have in place sound, effective and comprehensive

strategies and processes to assess and maintain on an ongoing basis the amounts, types and distribution of internal capital that they consider adequate to cover the nature and level of the risks to which they are or might be exposed”. Paragraph 311 of the EBA consultation paper refers in principle to this requirement. However, the EBA consultation paper is referring to “own funds” and not to “internal capital” as originally foreseen in Article 73 CRDIV.

The ICAAP should ensure that sufficient internal capital is available to cover all material risks. In this respect, and in contrast to Pillar 1, the assessment of risk is based on institutional specific processes reflecting an institution’s view on how much capital is need to cover all material risk. The competent authority uses the SREP to review the quality of the underlying processes of the ICAAP (see Article 97 and 98 CRDIV). Article 97 (3) requests the competent supervisor to determine whether the implemented risk management processes and strategies as well as their own funds and liquidity are sufficient to cover their risks. The SREP should therefore not only evaluate the appropriateness of Pillar 1 requirements but also the internal risk management processes and strategies. Article 98 (1) (f) CRDIV explicitly calls for taking into account the impact of diversification effects.

We do not support the limited point of view, where Pillar 2 would gradually become a “Pillar 1-add on-approach”. We strongly advocate a continuation of the current optional approach to methods implemented under Pillar 2 (principles-based), including the possibility to adequately take into account diversification effects and internal capital. Especially with regards to market risks and interest rate risks in the banking book as well as credit risk and credit spread risks, which are determined by the same risk factors, diversification is essential in order to derive adequate risk management incentives.

Diversification

- As regards diversification between risks, paragraph 319 states that “*diversification between risks... should not be considered as part of the determination of additional own funds requirements*”. This provision is not compliant with the provisions in the level 1 text. Article 98 of directive CRD IV that sets out the criteria that are to be factored in the SREP clearly provides at paragraph (f) that “*In addition to credit, market and operational risks, the review and evaluation performed by competent authorities pursuant to Article 97 shall include... the impact of diversification effects and how such effects are factored into the risk measurement system*”.

It is our view that diversification between risks is a key strategic choice for some institutions that has proven to be an effective and strong risk mitigant in the context of the recent financial crisis. It is, therefore, our view that the benefits of conducting businesses across diversified activities should be fully reflected in the EBA’s SREP

guidelines both in the BMA (Business Model Analysis) and in the TSCR (Total SREP Capital Requirements) quantification provided at paragraph 334.

- In a similar way, a number of institutions have built their strategy around diversification across geographies. The benefits of diversification and the costs of concentration are actually two sides of the same concept. They are consequently measured and monitored through the use of internal models which are capable of coherently measuring both. It is standard practice in the industry that both diversification and concentrations on geographies (or on any other relevant dimension in a portfolio) be factored into a bank's transaction pricing system. If we agree that diversification should be cautiously assessed and not overestimated, we strongly disagree that the key feature of a bank's business model be simply dismissed in the SREP context and in the TSCR quantification. The SREP itself should foster sound risk and capital pricing across the European financial industry. Failing to recognize diversification will inevitably increase the price of loans to clients especially in the case of the most diversified portfolios.

Finally, inter-risk diversification also seems essential :

- With Pillar 2, several risks are cumulated to the three ones of the Pillar 1. Just adding (ie regardless of correlation) 6 or 7 risks would imply that all extreme risks occur at the same time, which seems unrealistic !
- Solvency 2 (also an EU regulation) already allows diversification,
- this would keep the link between SREP and management tools (Plan, EVA / RAROC, pricing...),
- the Universal model for banking should be preserved (not the Northern Rock model),
- It also allows to identify the risk of concentration which must be considered by banks in their ICAAP.

Inter-risk diversification normally represents a small amount of reduction (less than 10 %). If regulators fear this concept, an only partial recognition with a cap could be implemented for a transition period ; and using CEBS rule on correlation recognition which are still valid.

We understand from our meeting with the EBA on 6 October that intra-risk diversification is allowed. This includes, for example, the geographical and sectoral diversification in credit risk and the use of correlation between corporate credit risk and retail credit risk in models.

However, inter-risks diversification should also be authorized to meet the level 1 text Article 98 of directive CRD IV and economically for the above reasons.

The role of benchmarks

Benchmarks could possibly be used only if they are relevant to a bank and should be adjusted to reflect the key features of its activities and portfolios.

The use of supervisory benchmarks is strikingly promoted in the guidelines overall, especially to assess the ICAAP reliability, as stated in paragraphs 317 to 329 (*“competent authority should further assess the reliability of the ICAAP calculations by comparing them against the outcome of the supervisory benchmarks for the same risks...”*). We suggest complementing those paragraphs and clarifying that, where an ICAAP calculation is not deemed reliable, supervisory benchmarks and other relevant inputs possibly used to determine potential additional capital requirements will be discussed as part of the aforementioned SREP dialogue. It is indeed of paramount importance that Supervisors engage into bilateral discussions with banks so as to obtain a good understanding of the data, assumptions and rationale behind those supervisory benchmarks and other inputs, as well as their results, before reaching a formal conclusion about potential additional capital requirements. Even though we recognise that benchmarks can be of interest in the context of internal models and ICAAP assessments, we would like to emphasise that their systematic use, especially if not thoroughly discussed and if mechanically applied, can have disastrous negative side effects from a supervisory perspective, by fostering poor risk management practices and / or riskier business models while at the same time failing to reward sound risk management and strong business models.

Assuming that we interpret the EBA guidelines under consultation correctly, the required capital according to institutional specific risk models is compared to benchmarks only in cases where the ICAAP process gives rise to doubts. If benchmarking is mechanically applied and becomes inherent in the SREP process, the risk exists that it will not be the actual calculations of the institution that are the decisive factor, but the higher of the two (worst-case scenario).

We consider it to be indispensable that, as part of the supervisory dialogue, institutions get to know their benchmark score and how it was calculated.

Equally, institutions should be entitled to know to which peer group they belong. Deviations can be analyzed and understood only if the aforementioned information is available. Furthermore, deviations should not automatically lead to doubts regarding the internal modelling. A too strong focus on benchmarks by the competent supervisors could lead to unintended effects, e.g. propagation of systemic risk / model risk and pro-cyclicality, which is certainly not the aim of supervision.

We understand from our dialogue with EBA that benchmarks in the Consultation Paper should be understood as a control methodology used to challenge the banks

internal capital estimates. This should apply to risks such as foreign exchange lending, and basis risk.

Benchmarks are tools to start a dialogue between supervisors and banks. They are different from peer group reviews. The final paper will clarify this point in order to avoid any misunderstanding.

The reconciliation with existing buffers

Reconciliation of the TSCR (Total SREP Capital Requirements) with capital buffers and other macro-prudential measures is an important issue. Paragraph 333 states that “*competent authorities should reconcile the additional own funds requirements against the risks already covered by capital buffer requirements and / or additional macro-prudential requirements*” and paragraph 484 that “*where a macro prudential measure, due to its design specificities, does not capture a particular institution... the competent authorities may consider extending the effects of the measure directly to that institution...*”.

We are of the view that macro-prudential measures should be dealt with through arrangements and processes that ensure appropriate coordination between supervisory bodies, as provided by Directive CRD IV and the CRR regulation, and should not be remediated on a case-by-case basis as part of the SREP, which would be detrimental to convergence of supervisory practices in the EU.

Other issues on capital

It should be clarified in the final text that:

- there are no links between scores and additional capital requirements.
- the conclusion of the SREP for capital quantification will in all cases be a potential increase of minimum capital requirement (and never an increase in RWA).
- Non transparency of this additional minimum capital requirement: we understand that this SREP increase of minimum capital requirement will not be disclosed to the market. Therefore, it should be stated in the final document that this SREP buffer / Pillar 2 surcharge, if any, does not count in the trigger level(s) used for the issuance of the additional Tier 1 and Tier 2 instruments, and will have no impact on the Maximum Distributable amount under article 141 of the CRD4.

Liquidity in SREP

References to liquidity are too general. It is difficult to understand how to see the role of liquidity in the process, especially taking into account the experimental nature of new liquidity requirements such as LCR and NSFR.

The text often suggests that there is an analogy between the treatment of liquidity and capital. But a deeper analysis of the different nature of capital and liquidity regulation seems necessary.

For instance, the LCR is a stressed ratio that can be used in a situation of market tension (that is, it can exceptionally be below 100%). Therefore, the use of stress tests for the LCR is not obvious, and in any case it needs to be different from those on the capital context.

Some references of cross-border implications of the liquidity analysis are also missing. Liquidity is local in nature (for instance by currency) which implies that in the case of cross border banks this needs to be taken into account when setting *inter alia* individual or consolidated requirements. There is also a need for references to the idea that diversified funding is a source of resilience.

Holistic view and final judgment

The final potential impact of a Pillar 2 surcharge, if any, should be based on :

- Pillar 1 and existing buffers,
 - bank's evaluation : the ICAAP results with its idiosyncratic dimension
 - supervisor's proxies / benchmarks under the conditions set above
- and above all, on a flexible way, and after a thorough discussion with the bank.

BSG would appreciate the EBA's consideration of the points raised in this submission.

Submitted on behalf of the EBA Banking Stakeholder Group

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