Comments

on EBA's Draft Guidelines for common procedures and methodologies for the supervisory review and evaluation process under Article 107(3) of Directive 2013/36/EU (EBA/CP/2014/14)

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Berlin, 20 October 2014

The **German Banking Industry Committee** is the joint committee operated by the central associations of the German banking industry. These associations are the Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (BVR), for the cooperative banks; the Bundesverband deutscher Banken (BdB), for the private commercial banks; the Bundesverband Öffentlicher Banken Deutschlands (VÖB), for the public-sector banks; the Deutscher Sparkassen- und Giroverband (DSGV), for the savings banks finance group; and the Verband deutscher Pfandbriefbanken (vdp), for the Pfandbrief banks. Collectively, they represent more than 2,000 banks.

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Executive summary

The German Banking Industry Committee (GBIC) welcomes the opportunity to comment on the EBA's consultation paper. Before responding to questions 1 to 6, we would like to make some general comments on the draft guidelines.

Including an **analysis of business models and of the sustainability of business strategies** in the SREP guidelines introduces an important new element to banking supervision. The benefit of this new element will lie above all in the information which will assist in planning and support the other elements of the SREP. We would strongly oppose any inference that supervisors should have a say in banks' business policies. Supervisors should not see themselves as "better bankers" than the banks themselves. Nor, as representatives of the state, are they in a position to assume the responsibility associated with playing an active role in business policy decisions. This is a task for the banks' owners and management alone.

Furthermore, the proposed guidelines **significantly extend the authority** of supervisors in a number of areas. In addition to the direct analysis of the business model and the ability to impose risk management requirements and play a part in the allocation of capital, there is potential for interference in a bank's management and business policy. This lies outside the remit of banking supervision, as we understand it. Pillar 2 of the Basel framework was designed as a basis for banks' *internal* management processes. A joint exercise of business management by supervisors and banks would be the wrong approach, in our view.

We believe that, by neglecting to take internal capital into account and focusing solely on own funds, the EBA is exceeding its mandate. CRD IV requires the SREP to relate to banks' internal processes for assessing their capital adequacy (**ICAAP**), which draw on internal methods of measuring their risks and calculating how much internal capital is needed to cover them. CRD IV also expressly requires the impact of diversification effects to be taken into account. As a result of the EBA's "Pillar 1 plus" approach, the relevance of internally generated management input would be sharply reduced under Pillar 2 and regulatory capital requirements could rise significantly above the level required under Basel III. **We therefore strongly advocate both retaining the existing ability for banks to select their own risk management methods in Pillar 2, since this is essential to holistic management processes, and continuing to recognise internal capital and diversification effects across risk types.** In addition, the effect of the proposed guidelines on the level of capital requirements should be thoroughly analysed in an impact assessment study.

We believe the **concept of proportionality** is insufficiently reflected in the draft guidelines. Apart from the guidance on the frequency of supervisory engagement, it is generally not clear in which respects there would be lower expectations towards small, less complex banks. Yet the impact on banks of different sizes depends very strongly on the interpretation of the proportionality principle. We therefore consider it essential to revise this aspect of the guidelines and include much more specific indications of how the principle of proportionality should be applied.

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It is also unclear, in our view, how banks and supervisors are to find the resources to cope with the **high intensity of the envisaged analyses**, such as the full annual assessment of all SREP elements at category 1 institutions. Greater emphasis should be placed on the concept of risk, which underlies the proportionality principle. Not all elements should need to be assessed annually, for example, but only those whose type, scale and degree of risk deserve such intense analysis. There are certain units, processes and areas in all banks where nothing changes in the course of a year. Less frequent analysis of these elements should be scheduled from the outset. On top of that, we consider a three-yearly assessment inappropriate for category 3 and 4 banks, in terms of both cost and risk.

We see a danger of the standardised analysis and associated **scoring** creating a deceptive impression of precision and triggering the automatic introduction of measures. This is not in keeping with the spirit of Pillar 2, in our opinion. The peer group approach should also be flexible enough to allow a proper assessment of individual banks. It should be possible for supervisors to overrule the formal results of the scoring process if there are sound grounds, such as qualitative considerations, for doing so. Moreover, the scoring criteria should be described in such a way that there is a realistic chance of even a conservative supervisor assigning a score of 1.

Another major new element of the SREP is the **proposed comparison with benchmark models** and peer group results. It will be essential, in our view, to disclose the calculation method of the benchmark to banks in the course of the SREP dialogue. The same goes for the reasons for assigning banks to a particular peer group. This is the only way to ensure banks have the chance to analyse any deviations and offer a satisfactory explanation for them. The mere fact of deviating from the benchmark cannot, in itself, be a reason to question the integrity of a bank's internal calculations. On top of that, strong reliance by supervisors on benchmark comparisons would risk forcing all banks in Europe to act in the same way. This would ultimately increase systemic risk and exacerbate procyclicality, which cannot possibly be in the interests of the supervisory community.

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Replies to the questions

Question 1
Do the guidelines specify the SREP process sufficiently? Are there areas where the EBA should aim for greater harmonisation, or where more flexibility would be appropriate?

We understand the primary objective of the SREP guidelines to achieve greater harmonisation of European supervisory practices when applying Pillar 2 of the Basel framework. The best approach, in our view, would be to retain practices that have proved their worth to date. Experience has shown that **proportionate principles** are one of the best ways of achieving effective supervision. Principles-based approaches that cover all material types of risk are far preferable to rules-based approaches under Pillar 2 because they facilitate a more comprehensive coverage of banking practices. It is virtually impossible to cover all conceivable types of banks with a rules-based approach, and regulatory gaps inevitably open up. For some banks, these gaps bring benefits in the form of capital relief, while for others they bring drawbacks in the form of additional capital requirements. Experience has been positive, on the other hand, in member states which apply a principles-based SREP framework. It is fair and right that the SREP should be applied as consistently as possible across the EU. This should not, however, lead to a situation in which the ability of management and the supervisory board to take risk and business management decisions is restricted by excessively detailed rules. Given the diverse nature of Europe's banking and financial industry, proportionate, principles-based SREP practices are essential if all institutions and their business and risk profiles are to be covered by one and the same framework. Banks should remain free to select their own risk management methods as long as they comply with certain essential requirements. This is the approach which has been adopted in several member states, such as Germany with its Minimum Requirements for Risk Management (MaRisk). It cannot be in the interests of supervisors to create a strictly rules-based Pillar 2 approach which can no longer be used for internal risk management purposes. What is more, we see a danger of a uniform, rules-based framework encouraging all banks to behave in the same way. This would ultimately increase systemic risk and exacerbate procyclicality in Europe.

The EBA's draft guidelines contain a high degree of regulatory detail. Some of the processes are spelled out exhaustively. An enormous number of criteria need to be individually investigated and assessed (cf. Titles 4, 5, 6 and 8). At the same time, the question frequently arises as to how, precisely, the individual criteria are supposed to be assessed and what undefined expressions such as "material", "very high", "medium", "low", "appropriate", "adequate", "significant", "specific", etc. will mean in practice. We assume that these points will be clarified in the supervisory handbooks of the competent authorities and the EBA and that banks will have a chance to ascertain what will be expected of them. In addition to this transparency, an adequate level of comparability with respect to assessments and procedures should be ensured across supervisory jurisdictions.

As a result of the envisaged degree of detail, we anticipate that national supervisors will have to put significantly more resources into the SREP. Banks which are not directly supervised by the ECB will have to be regularly reviewed with a thoroughness that is possibly neither

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necessary nor appropriate, especially for smaller retail institutions with comparatively simple business models. These reviews will also tie up considerably more internal resources at the banks and lead to rising supervisory fees. With this in mind, we have doubts about the plausibility of some of the assessments made in the draft cost-benefit analysis in section 5.1 of the consultation paper and would suggest that they be reviewed.

A number of assessment criteria are based on information or data currently collected, processed and documented by banks in varying ways and purely for internal purposes. If there are plans to introduce regular reporting requirements significantly over and above the existing reporting by banks to supervisors, the associated time and expense would need to be taken into account. There would, moreover, be a danger of this leading to enforced standardisation since supervisors might not wish to deal with differently structured and formatted risk reports, for instance, from hundreds or even thousands of individual banks. We assume that such standardisation is not intended and would appreciate clarification of this point.

The expression "if available" is used at various points in the draft guidelines. There is often no indication of how supervisors should proceed if the information in question is not available. We assume that institutions will not be disadvantaged solely on the grounds of unavailable, non-obligatory data and suggest a clarification to this effect.

We are concerned that the standardised analysis and associated scoring mechanism may create a deceptive impression of precision and trigger the automatic introduction of measures. This would not reflect the spirit of Pillar 2, in our opinion. Having studied the two additional draft guidelines[1] recently released by the EBA, our understanding is that any measures taken will be at the discretion of the regulator, i.e. the intention is not to put in place an automatic escalation mechanism based on SREP scores. The peer group approach should also be flexible enough to allow a proper assessment of individual banks.

It should be possible for supervisors to overrule the formal results of the scoring process if there are sound grounds, such as qualitative considerations, for doing so. We assume, moreover, that there cannot be – and that there are no plans to develop – a standardised algorithm for calculating the overall SREP score under Title 10 since the overall assessment depends on the business model, risk profile and many other individual factors.

At present, the "considerations" on which the scoring system is based are sketchy on detail and cannot be regarded as especially precise categorisation criteria. To achieve a score of 1, banks will need to be virtually risk-free and have a demonstrably prefect business model. Yet entering into risks lies at the heart of the banking business. Score 4 banks will be on the brink of insolvency. It is highly probable, as things stand, that the vast majority of European banks will be assigned a score of 2 or 3. We believe these scores should be validated with the help of a data history to ensure that they are sufficiently precise and robust.

At the public hearing, the EBA stressed that the scores themselves would matter far less than findings and measures. It is nevertheless striking that substantial space is given over to how

[1] "Draft guidelines on early intervention triggers" and "Draft guidelines on failing or likely to fail".

the score will be calculated, suggesting that it will indeed be considered highly important. Furthermore, some supervisors will, as the EBA itself also sees it, take an especially risk-averse approach and tend to "mark down" the institutions they evaluate. We would therefore suggest describing the score criteria in such a way that obtaining a score of 1 is a realistic possibility. We would also recommend investigating whether a spreading of the results would make good sense.

We regard the SREP assessment and the TSCR as a capital charge for an individual bank, and believe this should be a strictly bilateral matter between the competent authority and the bank in question. It should be ensured that there is no obligation to disclose SREP results. The competent authority should therefore consider all the relevant legal issues, such company law/stock corporation law requirements, when coming to its decision.

While we understand the EBA's wish to promote consistent methods and procedures for the Pillar 2 supervisory review and evaluation process, these must be based on the requirements of CRD IV.

We are consequently deeply concerned about the incompatibility of the proposed guidelines with CRD IV and the ensuing implications for the internal capital adequacy assessment process (ICAAP). CRD IV clearly intends that the SREP should relate to the internal process of determining capital adequacy (ICAAP). The ICAAP and SREP are therefore two inseparable elements and their homogeneous interaction is essential to an effective implementation of Pillar 2. This is explicitly set out in Article 104 of CRD IV, which requires competent authorities to take account of the quantitative and qualitative aspects of the ICAAP under Article 73 and the internal arrangements, processes and mechanisms set out in Article 74 when imposing any additional capital requirements on the basis of the SREP. While article 104(1)(a) CRD IV gives competent authorities the power to determine additional own funds requirements, we construe this power to be restricted to singular cases only. In other words, article 104(1)(a) CRD IV does not affect the internal capital definition of article 73.

The ICAAP is described in Article 73 of CRD IV. Banks are required 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 draft EBA guidelines reflects the gist of this requirement, but refers to "own funds" instead of "internal capital".

As we understand it, the purpose of the ICAAP is to ensure that banks hold sufficient internal capital to cover all material risks. Unlike under Pillar 1, risks are measured using banks' **internal methods**. The funds earmarked for covering these risks likewise reflect an internal view. The objective of the SREP is to enable competent authorities to evaluate the quality of the processes underlying the ICAAP. The main elements of the SREP are set out in Article 97 in conjunction with Article 98 of CRD IV. Article 97(3) explicitly requires competent authorities to determine whether or not banks' risk management, own funds within the meaning of Pillar 1 and internal capital within the meaning of Article 73 of CRD IV are adequate to ensure that all risks are covered. The function of the SREP is therefore to evaluate, first, compliance with the minimum standards under Pillar 1 and, second, risk management and internal capital adequacy under Pillar 2. Article 98(1)(f) of CRD IV expressly requires **diversification effects** to be taken into account.

We believe that, by neglecting to take internal capital into account and focusing solely on own funds, the EBA is exceeding its mandate.

To avoid misunderstandings, we would like to outline our understanding of the EBA's approach to calculating additional capital requirements to cover the risk of unexpected losses. This approach is illustrated in the left-hand box of the chart on the following page.

As we see it, the EBA proposes that a comparison be made per risk between the internal capital requirement and the Pillar 1 capital charge for the Pillar 1 risk in question (risk-by-risk approach). If there is reason to believe that the bank's ICAAP is in most instances not reliable, the capital requirement calculated by using internal risk models will, in addition, be compared to a supervisory benchmark for all risks for which no capital is set aside under Pillar 1. Requiring internal capital requirements to be compared to supervisory benchmarks as a matter of course would, in our view, run the risk of undermining the relevance of banks' internal calculations, since the higher of the two calculations (worst-case result) might always have to be used. We would nevertheless ask the EBA to make it clear that prudential benchmarks will not be applied to Pillar 1 risk types (credit risk, market risk, operational risk).

A capital add-on will always be imposed, as we understand it, if the amount calculated using the internal risk model is higher than the Pillar 1 capital requirement. The possible additional capital requirements for credit, market and operational risk will be added together and then supplemented further with a capital requirement for concentration risk, interest rate risk and possibly model risk as well. No account will be taken of inter-risk diversification effects. We are concerned that the end result will be the most capital-intensive of all possible requirements. This method of calculation is likely to lead to significantly higher overall capital requirements and to a methodological intermixing of the possible ways of determining them. It is not, in our view, a suitable basis for a bank's overall risk management or, in particular, capital allocation.

If the bank's ICAAP is consistent with the requirements of CRD IV, however, the overall risk should be calculated using internal methods (including the consideration of diversification effects), then compared with the internal capital set aside to cover this risk (middle box of chart). An additional capital requirement would only be imposed if insufficient internal capital was available.

We therefore believe it would be appropriate to take a holistic view of the bank and take adequate account under Pillar 2 of economically sound diversification effects between risk categories (right-hand box of chart). The first step would be to calculate the bank's overall need for economic capital and, if necessary, discuss the result with supervisors. This amount would then be compared with the overall capital requirement determined under Pillar 1. We consider it essential to take account of diversification effects with respect to risks determined by the same risk factors, such as general market risk and interest rate risk in the banking book, or credit default and credit spread risk. This is the only way to arrive at figures that can

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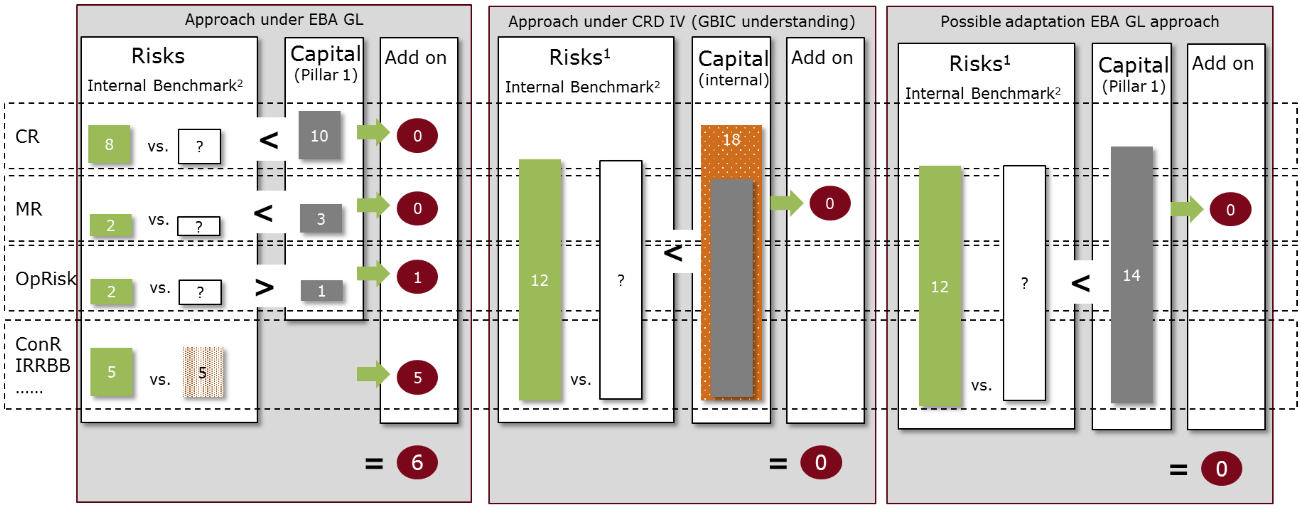
realistically be used for risk management purposes. At the very least, banks should be permitted to factor in the effects of diversification across risk categories if these are calculated in a sufficiently conservative manner and in compliance with certain requirements. Risk measurement models which have been approved by supervisors and which are used by banks for internal risk management purposes take account of diversification effects. Take, for instance, the quantification of the price risk associated with equities, which will include implicit diversification effects between market price risk and credit risk. It would not be appropriate, in our view, to separate the two.



1 Recognition of diversification effects
2 Benchmarking only if ICAAP methodology insufficient. Clarification necessary in which cases benchmarks will be used.

We **strongly advocate** that the SREP be based on the following principles:

- The bank's overall risks and internal capital should first be considered separately under Pillars 1 and 2.
- Benchmark comparisons should only be used if they are needed to check the plausibility of total capital requirements calculated under Pillar 2.
- Account should be taken of diversification across different categories of risk.

This will mitigate the draft guidelines' inherent exaggeration of Pillar 2 capital requirements.

We would also like to stress that we do not believe it would serve a useful purpose to consider credit concentration risk as an additional risk. It makes little sense to determine credit risk and credit concentration risk separately under Pillar 2 since these are normally calculated as a single, integrated figure with the help of credit portfolio models. Banks would have to separate the two risks artificially. This could be achieved, for instance, by using the credit portfolio model to carry out two calculations – one with the actual portfolio, and one with a homogenised portfolio. The credit concentration risk would then be defined as the difference between the two results. This procedure would normally generate a Pillar 2 credit risk amount which was far less than the Pillar 1 capital requirement, while the additional concentration risk would be subject to a capital charge under Pillar 2. We are therefore firmly opposed to considering credit concentration risk as a separate risk.

It should also be borne in mind that Pillar 1 requirements are already set to rise in the coming years to address the lessons learned from the financial crisis. The possibility cannot be ruled out, in our view, that the calculation methods set out in Title 7.3 and 7.4 of the draft guidelines will impose additional capital requirements on top of those under Pillar 2, even on banks with an appropriate risk profile. This raises the question of whether the possible effects of the proposed guidelines have been analysed in detail and whether a further increase in capital requirements is intended and necessary. We believe add-ons to Pillar 1 requirements to should only be imposed if exceptionally high risks are identified at a bank and these risks are not adequately covered by the bank's internal capital.

We would therefore recommend carrying out an **impact assessment** and usability test of the draft guidelines along the lines of those conducted prior to the introduction of Basel I and Basel II. This tried and tested practice will enable, first, the impact of the guidelines on capital requirements to be investigated and, if necessary, adjustments to be made. Second, the practicability of applying the guidelines can be analysed from the perspective of both banks and competent authorities.

Another major new element of the SREP is the proposed comparison with **benchmark models** and **peer group results**. This approach is based on the assumption that the benchmark or peer group results can be considered an objective measure for judging an individual bank's calculations. In reality, however, benchmarks of this kind may deliver only limited objectivity and comparability. If capital adequacy is to be evaluated using risk-by-risk benchmark comparisons, the question arises as to how to ensure consistent definitions of individual risk types across Pillars 1 and 2 and the benchmark. In the absence of a standardised ICAAP in Europe, banks will continue to apply their own individual methods of determining key risk measurement parameters. This significantly limits the ability to compare results. It is therefore essential, in the course of the SREP dialogue, to disclose to banks not only the results but also the calculation method of the benchmark. The same goes for the reasons and criteria for assigning banks to a particular peer group. This is the only way to ensure banks have the chance to analyse any deviations and offer a satisfactory explanation for them. The mere fact of deviating from the benchmark cannot, in itself, be a reason to question the integrity of a bank's internal calculations. On top of that, excessive reliance by supervisors on benchmark comparisons would risk forcing all banks in Europe to act in the same way. This would ultimately increase systemic risk and exacerbate procyclicality, which cannot possibly be in the interests of the supervisory community.

<u>Title 3: Monitoring of key indicators</u>
The quarterly reporting and subsequent monitoring by supervisors of these indicators as part of the SREP will not, in our view, deliver any additional insight since some of this information is already reported under Pillar 1. Synergies with existing reporting should be exploited.

Irrespective of this point, we believe indicators are not really a suitable starting point for determining peer groups. This is because of their lack of comparability. Differences exist

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between methods of calibrating regulatory capital ratios, for instance. If, in addition, internal financial and risk indicators are used to help create peer groups, they will only be able to offer a basis for comparison – if at all – in a statistically adjusted form. Adequate consideration also needs to be given to national and sectoral differences when creating peer groups. All in all, we would suggest refraining from using further indicators. Regulatory liquidity and capital ratios, including the leverage ratio, already influence banks' business models and assets-liabilities management. The ECB has published a study on the leverage ratio (WP 1676) highlighting possible adjustment mechanisms regarding the credit quality of banks' assets. A more homogeneous banking landscape will ultimately generate greater systemic risk.

<u>Paragraphs 42 ff.</u>
We assume that the thresholds for the key indicators used will be disclosed to banks in the course of the SREP dialogue. This will enable institutions to align their internal management processes.

The terms "management body" and "senior management" are used at various points in the draft guidelines, but it is not totally clear how they are to be understood. The guidelines are evidently strongly geared to the one-tier board system prevalent in Anglo-Saxon countries, where management and oversight functions are exercised by a single body (board of directors). The two-tier board system common in countries such as Germany, by contrast, is based on a strict separation of executive management by a management board and oversight by a supervisory body. Under a two-tier board system, the assessment criteria set out in paragraph 85, for example, would need to be applied to the supervisory board rather than the "management body". We would recommend clarifying that, while respecting the spirit of the guidelines, some requirements, may need to be adapted to different systems.

<u>Paragraphs 101 f.</u>
The EBA's guideline no. 44 on internal governance recommends that a chief risk officer (CRO) should have sole responsibility for the bank's risk management. The intention is to ensure a clear separation between units responsible for concluding transactions and entering into the associated risks (front office) and the function responsible for independently monitoring and communicating the risk situation of certain business units or, in some cases, the entire bank (middle/back office). In Germany, the office which processes credit transactions is primarily responsible for certain monitoring activities and is consequently kept separate from front-office units where operations involving risk are concerned. In small and medium-sized German banks, the CRO is therefore frequently also responsible for the back office as well. This reflects the spirit of the EBA's draft guidelines. It should be clarified that, in such cases, the CRO may be responsible for both risk management and the back office without this having an adverse effect on the assessment of the bank's internal control framework.

<u>Paragraph 107</u>
We do not consider corporate culture a suitable assessment criterion. There is no generally recognised definition of the term. An assessment of corporate culture will always be highly subjective and virtually impossible to back up with objective criteria. We would therefore recommend dropping the corporate culture criterion and deleting paragraph 83c.

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Paragraph 488 – "consider institutions on a solo basis"
We assume that it will continue to be possible to apply waivers for subsidiary institutions and would appreciate clarification to this effect.

EBA Question 2
Do you agree with the proportionate approach to the application of the SREP to different categories of institutions?

In our view, the **concept of proportionality** is insufficiently reflected in the draft guidelines. Article 107(3) of CRD IV explicitly points out that "EBA shall issue guidelines, addressed to the competent authorities, … to further specify, in a manner that is appropriate to the size, the structure and the internal organisation of institutions and the nature, scope and complexity of their activities, the common procedures and methodologies for the supervisory review and evaluation process …". We do not believe that the present draft guidelines meet this criterion. Apart from the guidance on the frequency of supervisory engagement, it is not clear in most titles in which respects there would be lower expectations of small, less complex banks. Yet the impact on banks of different sizes depends very strongly on the interpretation of the proportionality principle. This also makes it more difficult to evaluate the guidelines. We thus consider it essential to revise the guidelines to include much clearer reference to recognition of the proportionality principle.

We therefore recommend a critical overall review of the evaluation criteria listed in the draft guidelines. This means, firstly, checking whether they are actually necessary for a supervisory assessment of all institutions (i.e. including category 3 and 4 institutions) and, secondly, examining on what information this supervisory assessment should be based. There should, for example, be materiality thresholds for country risk, securitisation risk and foreign exchange risk below which no explicit review and evaluation of the criteria are required.

A further example of insufficient application of the proportionality principle is the guidance contained in Titles 8 (Assessment of risks to liquidity and funding) and 9 (SREP liquidity assessment). While some paragraphs (e.g. paragraphs 386, 387, 398) expressly refer to the fact that the scale of risk management should be in line with an institution's size and complexity, most paragraphs do not contain any such reference. In this context, there is the danger that the required scale (e.g. diversity of stress scenarios) will overburden (small) institutions without delivering any benefit. In other cases (e.g. liquidity risk in foreign currencies or review of market access), the absence of any reference to proportionality may result in a substantial documentation burden, only to ultimately demonstrate that the institution in question has no risk exposure in this respect.

Though paragraph 398, which deals with liquidity transfer pricing systems, refers to dependence on a bank's size and complexity, it should still make clear that small, less complex banks are allowed to use simpler mechanisms than sophisticated liquidity transfer pricing systems.

Like in many other cases, full application of the guidelines will require a considerable extension of IT capacities in, for example, the following areas: intraday liquidity risk, behaviour-based adjustment of maturity structure as well as calculation and classification of cash flows. Particularly in these areas, relaxed requirements for institutions with a simple business model should be specified directly in the guidelines.

Furthermore, it remains unclear how both institutions and supervisors are to cope resource-wise with the **high intensity of reviews** including full assessment of all SREP elements (e.g. annually at category 1 institutions). Greater emphasis should be placed on the concept of risk underlying the proportionality principle. For instance, not all elements should have to be reviewed with the same frequency (e.g. annually), but only those whose type, scale and degree of risk deserve such intense analysis. All banks have operational units, processes or other areas where nothing changes in the course of a year. These should be classified from the outset as requiring less frequent analysis. On top of that, we regard a three-yearly assessment for category 3 and 4 institutions as unreasonable from both a cost and a risk angle. There are around 2,000 banks in Germany. Up to now, many less significant or non-systemically important banks have been assessed with a frequency of ≥ 5 years. The financial crisis did not reveal any need for shorter assessment cycles.

In addition, we recommend labelling the bank size categories A-D so as to avoid any confusion with the score grades of 1-4. This would make the supervisory nomenclature clearer.

EBA Question 3
Are there other drivers of business model / strategy success and failure that you believe competent authorities should consider when conducting the BMA?

Incorporating an analysis of an institution's business model and the sustainability of its business strategy into the SREP Guidelines is a major new element in banking supervisory practice. The benefit of this new element will come primarily in the form of the information supporting planning and the other elements of the SREP. But no right for supervisors to have a say in banks' business policies should be inferred. Supervisors should not perceive their role as "superior bankers". Nor, as representatives of the state, are they in a position to assume the responsibility associated with playing an active role in business policy decisions. Even in a new supervisory order, this is a task for the owners and the management appointed by them. Furthermore, the proposed guidelines significantly extend the authority of supervisors in a number of areas. As a result, there is a very real potential for interference in banks' management and business policies, not only through the direct analysis of the business model but also through the ability to impose risk management requirements and, above all, the important new power to play a part in the allocation of capital. Such interference is not covered by banking supervisors' remit. It should be borne in mind that Pillar 2 of the Basel framework was designed as a basis for banks' internal management processes. It would be the wrong approach, in our view, to use this instrument as a means of exerting a continual external influence by supervisors on the management of banks or of consequently exercising joint management by supervisors and banks. If supervisors exert direct influence on banks' business policies, we also see a danger of banks adopting business models which are likely to obtain good scores. This would encourage herd behaviour, thus increasing systemic risk.

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Paragraph 59
Strategic importance is measured not only in terms of "generating profits (or losses)". In some cases, institutions might be obliged by their statutes or special laws to offer certain products or services. In other cases, business areas which strengthen the relationship with major shareholder groups may be of great strategic importance. In paragraph 59 (a), "materiality of business lines" should be defined according to strategic importance, no matter how profitable these business lines are. Besides the above-mentioned "legal framework" as part of the business environment and the broader definition of "materiality" (based on strategic importance and not only profit contribution) of business lines, the proposed criteria for analysing the business model appear to be sufficient.

Paragraph 76
Judging by the "considerations", the universal banking model will generally obtain a better score than will specialist institutions. To obtain a score of 1, a bank has to have "no material asset and funding concentrations". We are deeply concerned about this approach. Thanks precisely to their high degree of specialisation, specialist institutions can have extremely sound business models, since they are frequently better placed than their unspecialised competitors to offer services in their chosen field. For this reason, a reference to specialisation should be included in the considerations.

EBA Question 4
Does the breakdown of risk categories and sub-categories proposed provide appropriate coverage and scope for conducting supervisory risk assessments?

Paragraph 223 ff.
In our view, use of the AMA categorisation for STA/BIA users is problematic, particularly as regards the further breakdown by business lines, types of product, processes and regions, which is not customary in this form. The benefit for supervisors is in no proportion to the burden for banks. Processing the data in the required manner ex post is simply impossible.

Paragraph 225 b
The definition in paragraph 225 (b) (ii) of model risk which must be considered part of operational risk should be consistent with other definitions set by regulators.
Under CRD IV, model risk is defined as "the potential loss an institution may incur, as a consequence of decisions that could be principally based on the output of internal models, **due to errors in the development**, implementation or use of such models".

What is more, in the "Draft Regulatory Technical Standards on assessment methodologies for the Advanced Measurement Approaches for operational risk", also currently presented for consultation by the EBA, Article 5(5) further specifies as follows: "As a specification of the paragraph 5(4), the following events, and the related losses, shall be **excluded from the scope of operational risk:** (a) events due to **wrong selection of a model, made through a formalized corporate process**; and (b) losses caused by **a pricing model where the potential exposure to the model risk had been previously assessed**."

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In order to ensure consistency of regulation, a similar specification should therefore be included in the present guidelines.

Paragraph 225 (b) (ii) should also specify that only operational risks – but not any credit risks – relating to the cases outlined are included in the operational risk assessment.

Paragraph 240
The breakdown of data in operational risk modelling is defined in a bank-specific manner in each AMA model. Due to the limited amount of representative internal and external loss data available, loss distributions cannot be calculated to any desired degree of detail. Modelling is hence typically based on suitable clusters of comparable data.
Model results cannot therefore usually be computed with the required granularity (products, processes) or may merely be allocated on the basis of model results that have been broken down differently. As a result, their value is limited.
We recommend analysing loss data instead of model results.

Paragraphs 244, 245
The specified sub-categories contradict the required AMA categorisation to some extent and are thus, if anything, confusing (e.g. "conduct risk" plays no role in the AMA categorisation). We recommend harmonising and reviewing the AMA categorisation.
"Conduct risk" issues which are to be included as sub-items in a separate risk category are currently already subsumed under compliance risk, meaning that they are already subject to more stringent requirements. Carving out a number of sub-items from the widely accepted definition of compliance risk is counter-productive and erodes clarity and transparency in risk management. What is more, the items specified are already covered today by corresponding rules.

Paragraphs 230 (i), 251
Managing the complexity of IT architectures and IT systems is of growing importance. We can therefore appreciate in principle why IT complexity is to be factored into supervisory reviews and evaluations. However, we regard it as problematic that complexity is usually a highly subjective and intuitive metric which has to do with difficulty and incomprehensibility. Despite many years of research in this area, no uniform market standard for measuring the complexity of IT systems and IT architectures has emerged. Existing models mostly use a combination of several indicators, usually assigning crucial value not to the absolute level of a single indicator but to the combination and development of these indicators. Accordingly, achieving comparability with peers is virtually impossible. In this light, we feel it is vital that supervisory assessments of IT complexity are based on uniform, understandable evaluation criteria.

As operational risk, reputational risk and model risk are separate types of risk, they should be assessed separately. In particular, an assessment of these risks should be clearly divided, and this division should be reflected in the structure of the present guidelines.

In addition, it should be made clear that there are is no intention to impose quantification methods for reputational risk as part of the SREP; otherwise supervisors should explain how such risk could be quantified. Reputational risks frequently result from other types of risk and may compound these through their public effect. The likelihood of reputational risk occurring or the consequences thereof cannot be quantified separately but are reflected in turn in other types of risk (e.g. liquidity risk).

Paragraph 280
As we made clear during the consultation on the IRRBB guidelines, we regard the breakdown into four subcategories of risk as a purely academic exercise. The models normally used by banks do not quantify these subcategories separately. We consequently see no benefit in making such a distinction.

Paragraph 284 (b)
This paragraph effectively introduces a new European requirement to count interest rate risk twice using two different approaches. There is no single standard in Europe for the two calculation methods as things stand. We would like to stress the importance of the proportionality principle in this context. Using two complex methods to manage interest rate risk is not a viable proposition for small banks. They should be permitted to opt for one or the other.

EBA Question 5
Do you agree with the use of a standard approach for the articulation of additional own funds requirements to be used by competent authorities across the Union?

We do not believe that the EBA's risk-by-risk approach, as we understand it, is suitable for management purposes (see in this connection our reply to Question 1). It means that Pillar 2 would be diverted from its intended purpose and downgraded to a "Pillar 1 plus". We strongly recommend retaining the existing freedom of methods under Pillar 2 that is necessary for integrated bank management and particularly the recognition of diversification effects between individual risks and internal capital.

Title 7.3, paragraph 335
The requirements for compliance with certain ratios presuppose that quantification of the specified risks is possible and appropriate. We fail to understand the separate inclusion of credit risk concentrations under point (b), as these risks are already part of the calculation of credit risk in the internal credit risk models. We would like to stress with regard to the model risk referred to under point (c) that, from a methodological standpoint, its quantification is feasible only to a very limited extent. We would appreciate clarification to the effect that quantification will not be mandatory. Otherwise additional supervisory specifications would be needed for methodological implementation.

Title 7.1.1, paragraph 320
Furthermore, despite centrally set supervisory benchmark calculations, we do not believe that ICAAP-based comparability of banks with peers or equal treatment appears possible in every case. There are, for instance, differences in the parameters for risk calculation to determine risk-bearing capacity under a going-concern approach and a gone-concern approach. The fundamental difference between these approaches does not allow comparability with peers.

Limiting the composition of capital under Pillar 2 (risk coverage potential) to regulatory capital instruments or components under Pillar 1 is inappropriate. In practice, there are instruments or components which, exactly like Pillar 1 instruments, have the capacity to absorb losses in full and are available to banks at all times. For example, general credit risk adjustments, which Article 62 (c) of the CRR states are only eligible to a limited extent for recognition as Tier 2 capital under Pillar 1, should be eligible for full recognition in calculation of capital under Pillar 2. After all, they meet the regulatory own funds requirements – particularly with regard to their loss absorption capacity. Paragraph 337 should therefore include an opening clause to this effect.

Title 7.7
It should be made clear that the score is to be assigned on the basis of an overall assessment. For example, the partial use of capital buffers should not, in itself, automatically lead to a score of 3.

Paragraphs 324-329
We assume that bank-specific processes and features can be adequately taken into account in the supervisory benchmarks developed by competent authorities. We therefore welcome it that paragraph 327 of the guidelines expressly points out that benchmark results may not be appropriate in every instance.

EBA Question 6
Do you agree that competent authorities should be granted additional transition periods for meeting certain capital and liquidity provisions in the guidelines?

Given their high level of detail, as well the methodological and organisational issues still pending, we believe that longer implementation deadlines are urgently needed not only for the mentioned provisions but also for all other requirements under the SREP Guidelines.

As already pointed out in our reply to Question 1, an impact study including a use test should first be carried out by national supervisors across banks of different sizes with different business focuses. Before the guidelines are finalised and take effect, their applicability in supervisory practice should be tested; at the same time, the potential impact on capital and liquidity requirements should be examined and calibrated. The implementation period of no more than twelve months left between finalisation of the guidelines and their planned entry into force on 1 January 2016 is much too short.

Paragraph 502 (b)
The EBA has published a number of guidelines on liquidity in recent years, e.g. Guidelines on harmonised funding templates, Guidelines on different retail outflows, Guidelines on asset encumbrance reporting, Guidelines on asset encumbrance disclosure, Technical Standards on additional liquidity monitoring metrics and Technical Standards on additional outflows in accordance with Article 423 of the CRR.

On top of that, guidelines on the entry into force of intraday monitoring metrics are still in the pipeline.

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Several of these guidelines will only take effect in the coming years and cannot, therefore, be applied as early as 1 January 2016. In the interests of clarity, this paragraph should list the individual guidelines in question.