European Association of Co-operative Banks
Groupement Européen des Banques Coopératives
Europäische Vereinigung der Genossenschaftsbanken

EACB Position Paper On draft GL for common procedures and methodologies for the supervisory review and evaluation process under Article 107 (3) CRD IV (EBA/CP/2014/14)

DRAFT

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The European Association of Co-operative Banks (EACB) is the voice of the co-operative banks in Europe. It represents, promotes and defends the common interests of its 28 member institutions and of co-operative banks in general. Co-operative banks form decentralised networks which are subject to banking as well as co-operative legislation. Democracy, transparency and proximity are the three key characteristics of the co-operative banks' business model. With 3.700 locally operating banks and 71.000 outlets co-operative banks are widely represented throughout the enlarged European Union, playing a major role in the financial and economic system. They have a long tradition in serving 215 million customers, mainly consumers, retailers and communities. The co-operative banks in Europe represent 56 million members and 850.000 employees and have a total average market share of about 20%.

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Executive summary

The members of the EACB welcome the opportunity to comment on the EBA draft GL under Art. 107 (3) CRD IV laying out provisions for common procedures and methodologies for the supervisory review and evaluation process. We see that there are a number of issues of concern that should be addressed with respect to this key element of supervisory framework.

Before commenting on the substance of the document, we would like to express our concern that the high level of abstraction may lead to misunderstandings and difficulties. We strongly regret that illustrative examples may only be given in the supervisory handbook, which however will not be available to banks.

In particular we would like to highlight that:

- The draft GL considerably widens the competences of supervisors, ranging from the direct investigation of the business and risk management, participation in capital allocation to intervention in the management and business policies. We believe that these tasks are beyond a Pillar 2 approach. Moreover, while we appreciate that the new supervisory approach recognises the need to perform a business model analysis, this should not imply interference with the operating policies of institutions. The supervisor should not be understood as a "better banker".
- The SREP should be based in the first place on the institution's internal procedures for the calculation of risks and internal capital to cover these risks, assessing capital adequacy (ICAAP). Moreover, while CRD IV explicitly considers risk diversification effects, the draft GL do not seem to be in line with such provision.
- The proposed draft does not adequately reflect the proportionality principle and the impact on institutions of different sizes seems too open for interpretation. In this respect the revised guidelines should provide more concrete information. In addition, the complete testing of all SREP elements annually for Category 1 institutions seem excessive. The technical resources to be deployed would overweight the benefits stemming from the monitoring of factors that do not change every year. Also the 3-year cycle for institutions in categories 3 and 4 is not appropriate and should be maintained at 5 years.
- We believe that the introduction of standardized testing and use of score values must be taken with caution. Introducing automatisms triggering supervisory measures is not in line with the spirit of Pillar 2 and does not allow sufficient flexibility in the assessment of individual institutions. The assessment of institutions' specific factors, and qualitative aspects should not be overruled. Moreover, with regard to the introduction of benchmarking on peer groups, it is essential to adequately explain the determination method of benchmarks and assignment to a specific peer group. However, a deviation from the benchmark should not be sufficient reason to question the institutions' internal assessments. In addition, a strong regulatory focus on benchmarks may increase systemic risk and procyclicality. The application of mechanic SREP requirements could prove as a source of procyclicality, for instance, when an institution falls in stressed conditions. A vicious cycle can result from the

application of mechanic capital add-ons to the SREP capital already cumulated. Coping with higher SREP ratios in a stressed situation will induce further problems generating additional capital moreover when there is no possibility for retained earnings. A moving target situation that further destabilises the institution should be avoided and the SREP ratios should level off, once a bank is stressed. This is also due to the fact that some of the risks that led to the SREP capital charges have already turned into events, and should thus justify the recourse to the capital previously set aside. For instance, this would be the case for a credit deterioration that justifies the drawing up from specified reserves, or a downgrade of a unit, or assets becoming doubtful that adversely affect the P&L leaving the remaining portfolio is of better quality. The definition of stress could be fine tuned with respect to the restructuring and resolution directive and further aligned with the GL on early intervention currently being developed. In fact, as long as there is the possibility to issue capital instruments and retain earnings, higher SREP ratios do indeed increase stability. On the other hand during stressed conditions stability is rather fostered by the use of the established buffer.

- Due to the high level of detail of the requirements and the outstanding methodological and organizational issues, a longer implementation period should be considered.

1. General comments

Before commenting on the substance of the paper we would like to express our concern that the future application of the guidelines may turn out the be problematic. First, due to the fact that it only describes the SREP, banks will have to identify for themselves what this means for their ICAAP as the complement to the SREP. While this may already be a challenge, the very high degree of abstraction of the paper make it even more difficult to identify the room of flexibility in the individual situation. We therefore regret the lack of any examples or illustrations, which could help banks to better understand the guidelines and their principles. We are surprised that examples for certain practices and approaches will be given in the "supervisory handbook", which however will not be accessible for banks.

All in all the draft GL represent a completely new supervisory approach, beyond supervisory convergence. While a strong emphasis is placed on benchmarking (48 references), there is hardly any room for qualitative assessments. The proposed methodology focuses the review process on score values and automatic measures, triggering capital requirements as the only solution. This seems far from the spirit of Pillar 2. There is a risk that the strong emphasis on benchmarks would force banks to act similarly, leading to increased procyclicality and systemic risk, which would go against the main intention of the supervisors.

Whereas we consider that the Business Model Analysis and the assessment of the sustainability of the entity's strategic plans are important elements for the supervisory practice, we are concerned that this might lead to an intromission of the supervisor in the entity's business policy, which must remain an internal issue. In effect, we consider that

these draft GL contain extended competences for the supervisory authorities, that may be inclined to act as a "better banker", interfering thus in the management of the entity beyond the competences linked to banking supervision. While we consider that the Basel III Pillar 2 is a good basis for internal bank supervision, we are worried that a continuous external influence would lead towards the wrong interpretative path.

In the framework of the Basel III Pillar 2, a principle-based approach should be preferred over a rule-based one. This would in fact be more responsive to reflect the different specificities of institutions and a tool to implement proportionality.

It should also be highlighted that cooperative groups which are supervised as one entity in accordance with Article 10 CRR should be treated as one also with regard to these GL.

We believe that the following wording should be added:

"In case of a central body with credit institutions affiliated to it that are wholly or partially exempted from prudential requirements in national law in accordance with Article 10 of Regulation (EU) No 575/2013, the requirements of these Guidelines shall only apply to the central body and the affiliated credit institutions as a whole on a consolidated basis.

For that purpose, any reference to an institution shall include a central body and all credit institutions permanently affiliated to the central body as referred to in Article 10 of Regulation (EU) No 575/2013 as a whole on the basis of the consolidated situation on a consolidated basis. Any reference to a group shall include a central body and all credit institutions permanently affiliated to the central body as referred to in Article 10 of Regulation (EU) No 575/2013 and their subsidiaries."

We also think that proportionality is insufficiently addressed and represented in the current provisions. Apart from the guidelines for the assessment of Interest Rate Risk for non-trading activities (IRRBB), we can barely recognize the application of the principle for smaller and less complex entities, for example via simplified provisions. Due to this, it is in general difficult to interpret the GL, since the effect on entities of different sizes depends on the proportionality principle. Therefore, we believe that it is necessary to revise the GL and make sure that proportionality is better addressed. Moreover, with regard to IRRBB, before it can be included in the SREP interest risk guidelines there should first be a determination of the guidelines on interest rate risk, which have not been finalised yet.

Regarding the supervisory review requirements for the different categories of institutions, we are concerned about the lack of clarity on how the available resources will be able to cope, on a yearly basis, with the required analysis of all elements of the SREP for Category 1 entities. Even in such big entities, there are some elements that remain unchanged in the course of a year, which makes the yearly analysis unnecessary. The introduction of a lower frequency for the evaluation of some of the elements should therefore be considered. In addition, a three-year cycle for Category 3 and 4 entities seems disproportionate. Since many of these entities are currently evaluated in cycles of five or more years, we can hardly find a justification for this increased frequency.

While we see the need for a standardized evaluation, we are concerned that this, together with the collection of score values, may give supervisors a perceived sense of

accuracy and thus encourage them to use the results to justify the automatic introduction of measures. This would go against the spirit of the Basel III Pillar 2. In this vein, it is necessary to allow for a degree of flexibility when assessing these values, and supervisory authorities should be able to overrule such outcomes when it is justified by other available qualitative information or factors not included in the calculation of the score. The GL should aim at placing the various SREP elements in context and at identifying risks and vulnerabilities that should be subject to the supervisory dialogue, without a need for a scoring system.

Furthermore, the proposed scoring system does not seem to allow for a realistic representation. According to the description, an entity with a score 1 would have a perfect Business Model and almost no risk, whereas a score 4 would imply that the entity is on the brink of insolvency. We therefore assume that most European entities would get scores 2 or 3. We think that the scoring system should be streamlined so that it becomes realistic to obtain a score 1, which would allow for a better reflection of the reality.

We would also like to comment on another of the main elements of the SREP, namely the introduction of benchmarking models and the subsequent comparison of values and results with the corresponding peer group. The assumption that peers' values are based on objective criteria is misleading and the resulting comparability should be relativized. It is advisable that the entities disclose not only the benchmark values, but also the method followed for determining those values. Furthermore, there is a risk that a strong emphasis in benchmarks would force banks to act similarly, leading to increased procyclicality and systemic risk, which would go against the main intention of the supervisors. Benchmark models should serve as a basis for supervisory dialogue. They could be used as a tool to identify areas of focus for Pillar II supervisory review and as a trigger for dialogue on those areas. Additional capital requirements should only be considered after supervisory dialogue and not alone on a basis of mechanical supervisory scoring model.

A further element of procyclicality could derive from the application of mechanic SREP capital requirements in stressed conditions. A vicious cycle could in fact result where higher SREP ratios will add on further problems generating additional capital when there is no possibility for retained earnings. A moving target situation that further destabilises the institution should be avoided and the SREP ratios should level off, once a bank is stressed. This is also due to the fact that some of the risks that led to the SREP capital charges have already turned into events, and should thus justify the recourse to the capital previously set aside. For instance, this would be the case for a credit deterioration that justifies the drawing up from specified reserves, or a downgrade of a unit, or assets becoming doubtful that adversely affect the P&L leaving the remaining portfolio is of better quality. The definition of stress could be fine tuned with respect to the restructuring and resolution directive and further aligned with the GL on early intervention currently being developed. In fact, as long as there is the possibility to issue capital instruments and retain earnings, higher SREP ratios do indeed increase stability. On the other hand during stressed conditions stability is rather fostered by the use of the established buffer. In fact, as long as there is the possibility to issue capital instruments

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2. Answers to specific questions

Q1: 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?

Firstly, we would like to highlight the importance of dialogue that currently exists between institutions and their supervisors under the SREP. Supervisory dialogue should maintain a central role in particular due to the existing specificities of both business models and national markets which need to be rightly understood and taken into account to achieve a fair and comprehensive SREP assessment of each institution.

Yet, the proposed guidelines on the SREP procedures and methodologies 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...)"].

It is our view that the draft guidelines should be firmly centred on this prime aspect of Pillar 2. Pillar 2 is a process that banks should establish 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.

We understand that the goal of the SREP GL is to reach greater harmonisation of the European supervisory practice in the framework of the Basel III Pillar 2. In this regard, a principle-based approach should be preferred over a rule-based one, since this would better respond to the need of reflecting different specificities and implementing proportionality. Such an approach is indispensable if we want to bring the great diversity of European institutions under the same supervisory framework without giving way to an uneven playing field.

To foster convergence in the fields of ICAAP/ILAAP, the guidelines should be complemented:

- indicating the range of acceptable methodologies, specifying that internal modelling and/or economic capital modelling can be used;
- rejecting any automatic calculation, Pillar 2 is not a kind of super pillar 1;
- clarifying how the proportionality principle should apply to institutions of categories 1 to 4, as defined at paragraph 11.

In fact, we observe that the proposed GL do not adequately fit with this principle-based approach. Some of the provisions contain highly detailed descriptions. The scope and the degree of detail of the criteria to evaluate different elements (Titles 4, 5, 6 and 8) will lead, in our opinion, to increased costs for the national supervisory authorities. Moreover, we consider it disproportionate to apply such criteria to smaller entities not falling directly under the supervision of the ECB, since this would lead to higher internal costs for those entities having a simpler, retail-oriented business model. Furthermore, there is a risk that this will lead to an harmonisation of reporting requirements, imposing the same obligation to all entities disregarding their size or business model.

While we agree that the SREP GL should provide for a greater convergence of supervisory practice, we are concerned that this may lead to reduced room to manoeuver in terms of risk management.

Finally, we believe that the hierarchy of capital buffers and pillar 2 requirements requires further attention:: as the potential additional minimum requirement under Pillar 2 / SREP will not be public in all jurisdictions, it seems impossible for market reasons to include this buffer in the calculation of minimum distributable dividends (capital conservation buffer) and of the conversion trigger. This situation requires further consideration or at least clarification .

Q2: Do you agree with the proportionate approach to the application of the SREP to different categories of institutions? (Title 2)

General Remarks
Within the EACB's membership we have not only large integrated co-operative banking groups but also more decentralised networks or looser federations of small co-operative banks, and independent entities such as UK building societies. Many of the instutions in these networks and federations are quite small, but nevertheless economically sucessful. So we are naturally concerned to see that the EBA GLs are proportionate, and appropriate, for smaller institutions, not only in intention, but also in practical effect.

We understand that the GLs need to be comprehensive to meet the needs of supervisors dealing with the largest and most complex banks across the EU. However, this very comprehensiveness creates the impression (notwithstanding periodic rubrics to the contrary) that every individual item must be considered - i.e. every box must be ticked. Whereas what is needed, in our view, is for supervisors - when assessing the smallest institutions - to make an intelligent selection of those items / risks / issues that are most relevant to that institution and its business model, and focus on those - rather than covering everything at lower frequency, or in less detail. That would lead both to misdirected effort by the supervisors, and probably an increased burden of information requests to the smaller institutions. And the end point would be that supervisors risk not seeing the wood for the trees.

We understand that EBA has to be careful, in providing flexibility, not to imply that the content of the Guidelines is generally optional, including - and especially - when it comes to supervising the major players. However, it has to be taken into consideration that the smallest banks in the EU are about 30.000 times smaller than the biggest groups and that a scaling of measures is inevitable. We therefore commend the approach taken in BRRD Article 4 where the text explicitly envisages simplified obligations (only) for smaller institutions, without reducing the demands on larger banks.

We noted the EBA had put forward a sensible idea in paragraph 36 (with specific reference to business model analysis) the use of thematic SREP assessments on multiple institutions with similar risk profiles and other similar specificities. While this clearly is an efficient tool in relation to certain kinds of BMA analysis, we think it could be used, and promoted, more widely as an efficient and proportionate way to carry out other elements of the SREP assessment for small institutions of a distinctive type - say, small co-operative banks or building societies with essentially the same business model and other characteristics. "

Specific aspects of proportionality

We consider it adequate to create categories of institutions. However, we would propose to class them according to letters A-D instead of numbers 1-4, since the latter would be rather associated with score values.

As stated above, we believe that proportionality should be better addressed when it comes to the frequency and criteria for the evaluation, especially for entities in groups 3 and 4. Therefore, we propose that a critical overall assessment of the evaluation criteria is carried out. In this vein, we propose the introduction of materiality thresholds under which the entity would be exempted from some evaluations. Furthermore, we would like to have more clarity about the frequency requirements and its practical implications for the supervised entity.

Regarding the creation of peer groups, we are concerned that these may not take into account all the entity-specific features, such as national and sectorial differences. The proposed peer-grouping may have as a result reduced comparability of the banking landscape, which will increase systemic risks and procyclicality.

In this context, we believe that excessive emphasis is placed on the use of benchmarks. Such instrument could possibly be used only if 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 to be used to determine potential additional capital requirements should be discussed in the context of SREP dialogue between the Competent Authority and the institution.

It is 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 admit that benchmarks can be of interest in the context of internal models and ICAAP assessments, we would like to underline that their systematic use, especially if not thoroughly discussed and if mechanically applied, can have extremely negative side effects from a supervisory perspective. In fact, they may foster poor risk management practices and/or riskier business models, while at the same time failing to reward sound risk management and strong business models.

Q3: Are there other drivers of business model / strategy success and failure that you believe competent authorities should consider when conducting the BMA? (Title 4)

The profit or loss generation should not be the sole factor to evaluate the strategic importance. In effect, some entities may be obliged by their statutes or special laws to offer certain products or services. In this vein, the definition given to "materiality of business line" (cf. 59.a) should be defined by its strategic importance, no matter how profitable the business lines are. Beside these two elements (legal framework and definition of materiality based on strategic importance rather than profit generation capacity), the proposed criteria to identify the areas of focus of BMA seems adequate.

Regarding the proposed scoring, we are concerned that the considerations presented for each score would advantage the universal bank model over other specialised entities. The fact that the consideration that "there are no material asset concentrations or concentrated sources of income" counts for obtaining a score 1, leaves in principle out specialised entities with a high degree of specialisation. In this light, an explicit mention to such specialized entities should be included.

Q4: Does the breakdown of risk categories and sub-categories proposed provide appropriate coverage and scope for conducting supervisory risk assessments? (Title 6)

The use of the Advanced Measurement Approach (AMA) by entities currently using the Basic Indicator Approach (BIA) and the Standardized Approach (TSA) is, in our opinion, problematic. The proposed further breakdown (especially in accordance to business model, products, processes and regions) seems inadequate and does not bear into consideration the increased costs and red tape for the entity.

Moreover, in this context we believe that risk diversification should also be recognised in the proposed GL. Currently, the draft paragraph 319 states that "diversification between risks [...] should not be considered as part of the determination of additional own funds requirements".

This provision does not seem in line with rules established in the level 1 regulation. In fact, Article 98 CRD IV, outlining the criteria that are to be factored in the SREP, clearly establishes 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 to some institutions, and that it has proven to be an effective and strong risk mitigant in the context of the recent financial crisis. Therefore, 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.

It should be noted that a number of institutions have built their strategy around diversification across geographies. The benefits of diversification and the costs of concentration are actually the 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) is factored in a bank's transaction pricing system. While we welcome that diversification should be cautiously assessed and not overestimated, we strongly disagree that such a key feature of a bank's business model is 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, and especially for most diversified portfolios.

Taking into account diversification (by risk, geographical, by activities etc.) seems essential, in fact:

- there would be several risks being cumulated under Pillar 2 to the three already envisaged under Pillar 1. A simple addition (i.e. regardless of correlation) of a number of risks would imply that all extreme risks occur at the same time, which seems at least unrealistic, from a risk management perspective;
- Solvency 2 (EU regulation) already allows diversification, and a level playing field must be guaranteed;
- diversification establishes the link with management tools (Plan, EVA/RAROC, pricing...);
- the universal model of banking should be preserved;
- It allows to identify the risk of concentration which must be considered by banks in their ICAAP.

The impact of diversification usually provides reductions which do not endanger the soundness of risk measurement (less than 10 %), but which are essential for consistent risk management. We believe that at least a partial recognition of diversification effects

(e.g. introducing a cap) should be implemented. For instance, CEBS rule on correlation recognition, which are still valid, could be used.

Q5: Do you agree with the use of a standard approach for the articulation of additional own funds requirements to be used by compete authorities across the Union? (Title 7)

Reconciliation of the TSCR (Total SREP Capital Requirements) with capital buffers and other macro-prudential measures is a crucial 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 believe that macro-prudential measures should be dealt with through arrangements and processes ensuring appropriate coordination between supervisory bodies, as provided by directive CRD IV and the CRR regulation, and should not be remediated on case-by-case basis as part of the SREP, which would be detrimental to convergence of supervisory practices in the EU.

We are also concerned by the possibility to require more capital based on an assessment of the risk of excessive leverage. Such risk is not clearly defined and could only be understood at this stage with reference to a minimum percentage level of the leverage ratio, while there is not yet a requirement under CRR for the leverage ratio as a Pillar 1 measure (with a transitional period envisaged until 1st January 2018). In addition, numerous banks share the view that the leverage ratio is not an appropriate metric for a bank's capital adequacy assessment as it is not risk-sensitive. It is absolutely critical that the leverage ratio remains the back-stop indicator it has been originally designed to be, and is excluded from the SREP.

The SREP approach should revolve around a thorough understanding of the risks borne by the institutions, and imposing a crude metric such as the leverage ratio as a core element of an institution's SREP assessment is against the spirit of Pillar 2 approach. Moreover, it would even have detrimental effects if it becomes its most stringent capital constraint.

Furthermore, the draft guidelines specify that competent authorities shall set a composition requirement for the additional own funds requirement under Pillar 2, of at least 56% CET1, or 75% T1 (para. 335). This seems to be stretching beyond the lines of CRR/CRD IV, imposing overly restrictive measures and extremely increasing the requirement of CET1. This will especially have negative consequences for non joint stock companies with limited access to common equity. This could lead even to an international un-level playing field.

Q6: Do you agree that competent authorities should be granted additional transition periods for meeting certain capital and liquidity provisions in the guidelines? (Title 12)

Taking into account the high degree of detail of the exigencies laid out in the GL, and of its methodological and organisational implications, we consider it necessary to grant additional transition periods.

The implementation period of one year from the final guidelines and their planned entry into force on 1 January 2016, is way too short. An impact study should also be considered, with tests of application by the national supervisory authorities at institutions of varying size and business orientation, to allow a more thorough calibration of the final provisions and considering likely capital impacts.