

11 April 2017

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# EBA Pillar 2 Roadmap

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## About this Roadmap

1. The objective of this Roadmap is to outline the EBA's plans to update the common European framework for the supervisory review and evaluation process (SREP) in 2017-2018. The comprehensive common EU SREP framework is well established since 2014 and has been applied in practice since 2016. In the EBA's view the framework remains robust and serves the purpose of ensuring convergence of supervisory practices well, but in the light of the recent developments in the EU and international fora, as well as EBA findings from the ongoing monitoring and assessment of convergence of supervisory practices, certain changes, explained in the Roadmap, are needed to reinforce the framework further.
2. The Roadmap explains the multi-stage approach to the update of the EU SREP framework in 2017-2018 and beyond, and recaps ongoing policy initiatives affecting Pillar 2/SREP that will need to be reflected in the revised EBA guidelines on Pillar 2 topics. Under this approach the first revision of the SREP framework will be introduced for the public consultation as soon as 2017, aiming for practical implementation in 2018.
3. In particular, the Roadmap explains the approach that the EBA is planning to take in relation to the following:
  - a. update of the EBA Guidelines on common procedures and methodology for SREP (SREP Guidelines)<sup>1</sup>;
  - b. update of the EBA Guidelines on technical aspects of the management of interest rate risk arising from non-trading activities in the context of the supervisory review process (IRRBB Guidelines)<sup>2</sup>; and
  - c. finalisation of the draft Guidelines on stress testing and supervisory stress testing (Stress Testing Guidelines)<sup>3</sup> after the public consultation.
4. The Roadmap also explains the key concepts of Pillar 2 capital guidance (P2G): a supervisory tool widely introduced into the supervisory toolkit in 2016 aiming to address supervisory concerns

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<sup>1</sup> See <http://www.eba.europa.eu/regulation-and-policy/supervisory-review-and-evaluation-srep-and-pillar-2/guidelines-for-common-procedures-and-methodologies-for-the-supervisory-review-and-evaluation-process-srep->.

<sup>2</sup> See <http://www.eba.europa.eu/regulation-and-policy/supervisory-review-and-evaluation-srep-and-pillar-2/guidelines-on-technical-aspects-of-the-management-of-interest-rate-risk-arising-from-non-trading-activities>.

<sup>3</sup> See <http://www.eba.europa.eu/regulation-and-policy/supervisory-review-and-evaluation-srep-and-pillar-2/guidelines-on-stress-testing-and-supervisory-stress-testing>.



over the capital planning as revealed by supervisory stress testing. These concepts have been agreed by the EBA Board of Supervisors and will serve as the basis for the approaches applied in the 2016 and 2017 SREP assessments as well as for the development of the respective section of the SREP Guidelines.

5. The rationale for the revisions of the Pillar 2 framework is to keep the SREP Guidelines that were published in December 2014, and are in force since January 2016, up to date with respect to the EU and international standards, promote best supervisory practices and address issues identified in the EBA's ongoing work on assessment of supervisory convergence.
6. Since the publication and first application of the SREP Guidelines there have also been a significant number of external developments that affect the SREP framework and need to be reflected in the updated Guidelines. In particular, this relates, for example, to the use of supervisory stress testing in SREP and wider introduction of P2G in the 2016 EU-wide stress test<sup>4</sup>, the revision by the Basel Committee on Banking Supervision of its IRRBB framework<sup>5</sup>, which needs to be implemented in the EU legislation, and the clarification of the European framework for the application of maximum distributable amount (MDA)<sup>6</sup>.
7. With respect to the European implementation of the revised Basel Committee on Banking Supervision (BCBS) IRRBB framework, it should be also noted that, in addition to the revision of the current EBA guidelines, the BCBS framework will also be reflected in the forthcoming revision of the Capital Requirements Directive (CRD), with the European Commission providing in its proposal<sup>7</sup> a number of the mandates for the EBA to develop technical standards following the adoption of the revised Directive.
8. Furthermore, during its ongoing work on the monitoring and assessment of supervisory convergence, the EBA has made a number of significant observations<sup>8</sup> with respect to the actual supervisory practices applied on the ground, as well as identified areas that need to be reflected in the EBA SREP framework and factor in the revision of the SREP Guidelines.

## 1. Revision of the EBA Pillar 2 framework in 2017

9. This section explains the approach to the review of the EBA Pillar 2 framework in 2017 focusing on (1) the revisions of the SREP Guidelines, (2) the revisions of the IRRBB Guidelines and (3) the finalisation of the Stress Testing Guidelines.

### 1.1 Revision of the SREP Guidelines

<sup>4</sup> See <https://www.eba.europa.eu/-/eba-clarifies-use-of-2016-eu-wide-stress-test-results-in-the-srep-process>.

<sup>5</sup> See <http://www.bis.org/bcbs/publ/d368.htm>.

<sup>6</sup> See <https://www.eba.europa.eu/documents/10180/983359/EBA-Op-2015-24+Opinion+on+MDA.pdf>. It is also noted that the BCBS planning to undertake further analysis in this area.

<sup>7</sup> See [http://europa.eu/rapid/press-release\\_IP-16-3731\\_en.htm?locale=en](http://europa.eu/rapid/press-release_IP-16-3731_en.htm?locale=en).

<sup>8</sup> See <https://www.eba.europa.eu/documents/10180/1360107/EBA+report+on+the+convergence+of+supervisory+practices>.

10. Revisions of SREP Guidelines in 2017 will include the following key topics: (1) introducing P2G and integrating supervisory stress testing, (2) providing more details on supervisory assessment of banks' stress testing, (3) aligning supervisory assessment of IRRBB with the revision of the IRRBB Guidelines, (4) clarifying certain aspects of the scoring framework, (5) better explaining interaction between SREP elements, (6) improving articulation of total SREP capital requirements (TSCR) and overall capital requirements (OCR), and (7) assuring consistency with recently published legislation on internal governance. The paragraphs below explain these planned changes in more details.

11. It should be noted that some of the revisions planned below are linked to the revisions of the Pillar 2 framework in the Directive 2013/36/EU (Capital Requirements Directive – CRD)<sup>9</sup> and the final text of the revised Guidelines will be adjusted to be in line with the final outcomes of the revisions to the /CRD.

### 1.1.1 P2G and supervisory stress testing

12. Section 7.7, 'Meeting requirements over the economic cycle', of the SREP Guidelines will be reviewed to strengthen an EU approach to using the outcomes of supervisory stress testing in the capital adequacy assessment process, and setting P2G. This section will be built on the work performed in 2016 and around the key concepts of P2G that are summarised below.

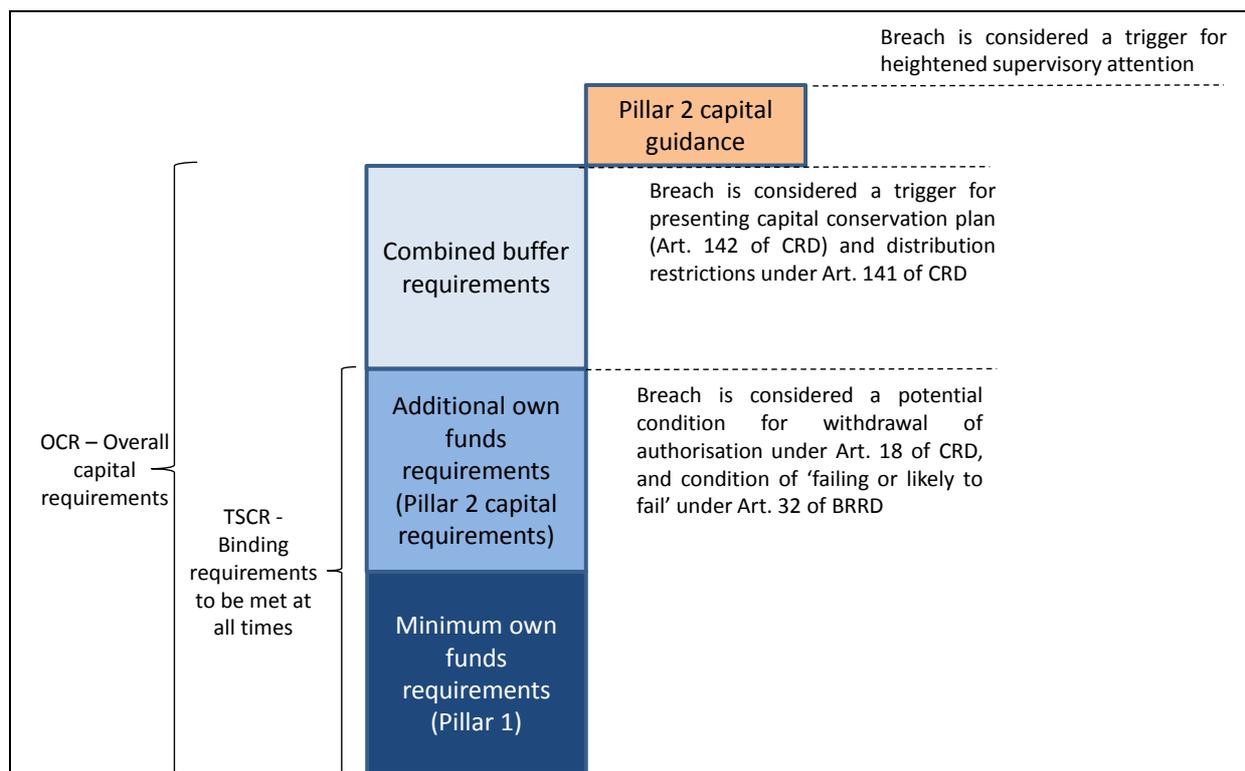
13. Given the close links between P2G and wider aspects of supervisory stress testing (e.g. specification of what forms of supervisory stress testing can be used to set or update P2G) this revision would also incorporate elements from the current draft Stress Testing Guidelines, in particular Section 6, 'Supervisory stress testing', and Section 7, 'Use of quantitative results for capital adequacy assessment purposes', which would also need to be reviewed to reflect comments received in the public consultation. This approach would allow consistent coverage and use of various aspects of supervisory stress testing in SREP, which is also an intention of Article 100 of the CRD.

#### Key features of P2G being explored for the revision of SREP Guidelines<sup>10</sup>

Pillar 2 capital guidance (P2G) is a supervisory tool setting non-legally binding capital expectations at level over and above overall capital requirements (OCR) based on the SREP findings, in particular (1) an assessment of the adequacy of an institution's own funds (quality and quantity), in particular the ability to meet the applicable own funds requirements in stressed conditions, or (2) supervisory concerns over the (excessive) sensitivity of an institution towards scenarios assumed in supervisory stress testing. As P2G is positioned above the combined buffer requirement and is non-legally binding guidance, it is not relevant for the purpose of the calculations of maximum distributable amount (MDA) (see chart below).

<sup>9</sup> See <http://ec.europa.eu/info/node/6089>.

<sup>10</sup> The key features of P2G explained here represent the current supervisory thinking and the approaches applied in the 2016 and 2017 SREP assessments. This might not reflect the final text of the revisions to the CRD and will therefore be adjusted accordingly once the CRD text affecting P2G is finalised.



P2G is expected to be established mainly based on the quantitative outcomes of the supervisory stress tests, and it is generally assumed that the reference point for the analysis is the quantitative outcomes of the supervisory stress tests under the assumed adverse scenarios.

P2G is expected to be set at a level appropriate to cover at least the expected maximum stress impact (i.e. the maximum depletion of the available own funds in the worst year). It may be further adjusted to consider management actions that are deemed credible following their supervisory assessments and other factors, including outcomes of stress tests performed as part of internal capital adequacy assessment process (ICAAP), in particular where ICAAP is assessed as reliable.

In addition, to determine the final level of P2G, it may be offset against the elements of the combined buffer requirements that serve the same purposes. The general assumption for offsetting P2G against elements of the combined buffer requirement is that both are seen as buffers to be used in times of stress. This, in particular, applies to the capital conservation buffer (CCB), as P2G and CCB overlap in nature, protecting institutions from breaching their applicable capital requirements under stressed conditions. Furthermore, P2G can be offset on a case-by-case basis against the countercyclical capital buffer (CCyB) based on the consideration of underlying risks covered by the buffer factored into the design of the scenarios used for the stress tests, and after liaising with macroprudential authorities as provided in the SREP Guidelines. There should, in principle, be no offset of P2G against Global or other systemically important institution (G-SII/O-SII) or systemic risk buffer, as those are intended to deal with the risk an institution poses to the financial system.

P2G should not be used to cover risks that should be covered by the additional own funds requirements (P2R) set in accordance with the EBA SREP Guidelines, nor should there be additional

own funds requirements imposed by means of P2R, where the identified deficiencies should be addressed by means of P2G.

When set, the level of P2G is expected to be communicated to the institutions together with the quality of own funds required to meet it (CET1) and all applicable own funds ratios affected by P2G (CET1, T1 and total own funds).

Institutions will be expected to meet P2G with CET1 own funds, and incorporate it into their capital planning and risk management frameworks, including their risk appetite frameworks. Institutions are also expected to incorporate P2G into their recovery planning, and in particular into the progressive metrics of recovery plan indicators, as an early warning-type signal.

Competent authorities would monitor whether or not the amount of own funds corresponding to P2G is established and maintained by the institution over time as part of their ongoing monitoring and assessment.

When an institution stops, or is likely to stop, meeting the P2G, it will be subject to intensified supervisory dialogue, in which the institution will be expected to provide the competent authority with a set of actions aimed at restoring own funds to meet P2G. This will not result in automatic actions by the supervisor and will not be used to determine the MDA trigger, but will be used in fine-tuned measures based on the individual circumstances of the institution.

Given that the amount of own funds corresponding to P2G should be regarded as an item over and above (in excess of) the institution's OCR also for the purposes of MDA, and considering the supervisory objectives of P2G, which is to act as a type of monitoring metric not automatically linked to any further supervisory measures, competent authorities would not require institutions to disclose capital guidance publicly. It should be noted, however, that competent authorities under the CRD do not have the legal powers to actively prevent institutions from disclosing P2G. Institutions are generally expected not to disclose P2G but they are expected to evaluate whether or not that information meets the criteria of insider information and, if so, ensure compliance with provisions of the Market Abuse Regulations<sup>11</sup>.

### 1.1.2 Supervisory assessment of institutions' stress testing

14. In addition to addressing issues of P2G and supervisory stress testing, the revised SREP Guidelines will also benefit from elaborating more on the supervisory assessment of institutions' stress testing frameworks and programmes that is currently covered in Section 5, 'Supervisory assessment of institutions' stress testing', of the draft Stress Testing Guidelines. To this end this section will be integrated into the revised SREP Guidelines. That will allow one set of guidelines to cover all aspects of SREP assessments in relation to stress testing.

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<sup>11</sup> Regulation (EU) No 596/2014.

15. The text on the supervisory assessment of institutions' stress testing will be reviewed in the light of the comments received in the public consultation on the draft Stress Testing Guidelines.

### 1.1.3 Other changes

16. In addition to the above changes, certain technical areas of the SREP Guidelines will be reviewed to ensure consistency with other EBA regulatory products that have been issued after its publication (e.g. Section 5, 'Assessment on internal governance and institution-wide controls', and Section 6.5, 'Assessment of interest rate risk from non-trading activities'). Furthermore, based on the findings from its assessment of supervisory convergence, the EBA will introduce some clarifications and additional explanations of the topics, including differences between risks and viability scores, interaction between the assessment of the four main SREP elements, and the communication of TSCR and OCR ratios to institutions. These clarifications will not change the policy direction, but will rather clarify the existing concepts.

17. Following the 2017 revision as explained above, the EBA will continue to keep the SREP Guidelines in line with market developments and will monitor their practical implementation. Some additional revisions may be needed on issues such as business model analysis and technical guidance on ICAAP/ILAAP linkages and their assessment criteria. Any revisions will also largely depend on the final outcomes of the revisions to the Pillar 2 framework in the CRD; the SREP Guidelines may require additional updates in line with CRD changes.

## 1.2 Revision of the IRRBB Guidelines

18. The IRRBB Guidelines published in May 2015, while addressing supervisory expectations and practices in IRRBB risk management and supervision that existed at that time, are also based on the BCBS Principles for the management and supervision of interest rate risk published in 2004. In April 2016, the BCBS published an updated version of standards on the management of IRRBB (BCBS Standards) to reflect changes in markets and supervisory practices since 2004. The banks are expected to implement BCBS Standards by 2018.

19. The implementation of the new BCBS Standards at the EU level will be phased in through two parts, and will be effected through an update of the EBA Guidelines as well as through a number of technical standards that are expected to be mandated to the EBA in the revised CRR/CRD.

20. The revision of the EBA Guidelines will reflect the new BCBS Standards and will include:

- a. clarification of definitions and expanding the scope of the guidelines to include credit spread risk in the banking book;
- b. update of parameters and assumptions of the supervisory standard shock;
- c. update of standardised interest rate shock scenarios; and
- d. update of requirements on internal governance arrangements.



21. The aim is to align the implementation of the revised EBA Guidelines with the 2018 implementation date for the BCBS Standards and, thus, bridge the time gap between the implementation of the BCBS Standards and technical standards.

22. Furthermore, after the update of the IRRBB Guidelines within the first phase, the EBA will start working on technical standards, given the new mandates for the EBA expected to be introduced by the revised CRR/CRD, including methodology for the standardised framework, supervisory shock scenarios, including common modelling and parametric assumptions, and, common modelling and parametric assumptions for the purpose of disclosure.

### **1.3 Finalisation of the Stress Testing Guidelines for banks after consultation**

23. As part of the planned revisions of the SREP framework explained in this Roadmap, the EBA will also finalise its draft Stress Testing Guidelines following its public consultation that took place in 2016.

24. All aspects related to the supervisory assessment of institutions' own stress testing, supervisory stress testing and the use of quantitative outcomes of stress testing will be incorporated into the revised SREP Guidelines. This will leave the draft Stress Testing Guidelines to focus on setting requirements for institutions (Sections 1-4 of the draft Guidelines). These requirements will be finalised taking into account comments received during the public consultation.

25. Based on the feedback received, the EBA is also considering expanding the draft Guidelines and providing additional details on the topics related to reverse stress testing, links between solvency and liquidity stress test, and links between stress testing recovery planning.

26. The finalisation of the draft Stress Testing Guidelines will be completed following the same timeline as for the revision of the SREP Guidelines. Given the planned changes mentioned above, the EBA will also organise a second public consultation of the draft Stress Testing Guidelines and will time it to coincide with the publication of the consultation of the revised SREP Guidelines, so external stakeholders will have a complete overview of the revised framework.

Annex

Key milestones of the Pillar 2 Roadmap (indicative timeline)

