



**Committee of European  
Banking Supervisors**

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**Consultation Paper 03 : The Application of the Supervisory Review Process under Pillar 2**

Ladies, Gentlemen

The European Association of Cooperative Banks (EACB)<sup>1</sup> welcomes the CEBS's initiative to develop convergent standards regarding the application of the supervisory review process under pillar 2.

The EACB therefore takes the opportunity to lay down its comments on the following pages.

We are ready at any time to continue our discussions with CEBS on these issues.

Yours sincerely

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<sup>1</sup> The European Association of Co-operative Banks represents over 4.500 co-operative credit institutions active in all the EU Member states and serving over 100 Million customers. Its member organisations are decentralised national networks of small-sized Co-operative banks' networks, which have a strong presence on a local or regional level. They account for a large part of the SME and private household credit market (17%) and thus play a crucial role within the Internal Market.



## 1. GENERAL REMARKS

This paper is to provide for achieving as great a convergence of regulatory supervision within the EU as is possible. It should therefore be further enhanced and detailed. However, it is equally essential to maintain some flexibility in reading and application, since it has to be kept in mind that any resulting constraints might only apply to European banks, which could be disadvantaged towards other institutions subject to Basel II.

The EACB supports the general principle of the separation of the Internal Capital Adequacy Assessment Process (ICAAP) and the Supervisory Review and Evaluation Process (SREP) and appreciates the care given to set up precise guidelines in order to achieve the greatest implementation convergence.

The ICAAP and SREP principles are drawn in the light of the Basel principles. Those concentrate on big international groups. Though the proportionality is included in the principles, however in most cases the wording is such that it is very difficult to know how compliance can be ensured for small institutions. The SREP seems to address issues which can be reviewed mostly at on-site inspections and require considerable resources from supervisors. It would be desirable if the simplifications for less complex institutions would be also highlighted in the principles.

Furthermore, we would like to underline that banks have to operate safely and slightly above the minimum capital requirements while this document seems to suggest that significant buffers are necessary and ignores essential risk mitigation as diversification. While the pillar 1 requirements lay down the standards for capital requirements, additional capital charges under pillar 2 must be an exception.

We are also afraid that some new concepts or risk taxonomy that we discover in the document should get a regulatory status while they still need to be discussed or appear controversial and the CEBS itself recognises that “there is no standard categorisation of risk types”.

For the purpose of avoiding misunderstandings and non-convergent application, we suggest that a principle of **material risks** is consistently applied throughout the document. This would be relevant both for the question whether the a risk has to be considered as material *per se* as well as to the question as to whether the consequences of the manifestation of such risk would be material in relation to the scope and type of a bank’s transactions.

The outsourcing of certain elements of risk management, in particular within decentralised banking groups is a key issue. It must be possible to outsource certain elements to specialised entities within a banking-group, e.g. validation of models, documentation of the design of the system, data maintenance, etc.

The consultation paper repeatedly gives the impression that management decisions may fall under supervisory discretion. The EACB has permanently pointed out that the SREP should not lead to a scenario in which supervisors take over the role of a bank’s management, which is equally supported by the substance of the Basel document.

## 2. DETAILED COMMENTS

Re 4. The two elements of SRP and ICAAP require to be explained in the banks’ view since, for instance, to a large extent, quantitative elements are not included although they could nonetheless be standardised and could thereby give rise to simpler regulatory controls in the



banking business. Furthermore, in the case of any quantitative elements, availability, especially for standard-approach banks, should be specified even more precisely.

- **Supervisory review process - SRP:**

The document doesn't define clearly how the SRP should be work in practice, in particularly whether the SRP should be applied at the consolidated group level. A part of the EACB's members favour an application at this level. Others, however, are concerned that extending the role of the consolidated supervisor to the SRP could lead distortions within EU national markets as local banks and subsidiaries of international groups could be submitted to diverging standards applied by different supervisory authorities though competing in the same market.

If application on a consolidated level is considered, it should also reflected whether similar approach could equally applied to non-consolidating groups, where certain risk management functions were "outsourced" to special entities.

In addition, there is no reference on the coordination of home / host regulators. This point should be specified.

Re 6 et seq. It is suggested to clarify what kind, form and frequency of processes, strategies and possibilities for verification there should be and whether there is a single manner of proceeding for banking groups and/or individual institutions.

Re 7- Principle 1: "a strategy for maintaining their capital levels"

The bank should have a strategy to keep its capital in line with its risk profile and not compel to maintain its capital level in absolute terms, which may not appropriate from an economical standpoint. Additional capital requirements shouldn't be systematic and above all the objective of the pillar II. The wording may be improved or at least understood in an open manner.

Re 8: In what form is it envisioned using the banks' existing risk systems and are additional requirements necessary for the banks? As a general rule, existing and proven risk systems should be admitted, at least as a basis that can be developed.

Re 11. The regulator's ability to demand that banks fulfil greater equity requirements on the basis of ICAAP should without fail be coupled to precise, comprehensible conditions.

Re 12. There should be some guidance as to which institutions are "larger, more complex and systemically important".

- **Key Considerations:**

Re 15. A distinction is welcomed, but this should be defined more precisely. In particular it should be made clear how the proportionality principle should be understood in the case of credit institution subsidiaries within a group?

Re 16. It remains open in what form all institutions in future will have to include the impact on the macro-economic cycle. Are the stress-testing frameworks to differ according to the individual bank or will there be a fundamental approach in this regard? For small institutions it may be high burden to assess the impact of economic cycles on capital. Moreover, it cannot be ensured that the task is done with adequate professionalism.



Re 17 It must be ensured, that the supervisory assessment would be really independent and that supervisors should not use the models used by the credit institutions. E.g. if the institution has a VAR model for market risks with a holding period of 1 day and a confidence interval of 95 per cent, in the supervisory review process this model should not be used to calculate a VAR for 10 day holding period and a 99 day confidence interval.

Re 19. In the case of banking groups, the jurisdictions of the relevant national and "superordinated" regulators are to be defined. The European Central Bank has been standardising the reporting formats for a while. It is clear that the final word on the consolidated level versus individual level will be that of the authorities.

Accordingly, a number of the EACB's members therefore strongly suggests that supervisory authorities should standardise the reporting formats in order to reduce cost. Other members, however, underline that the standardisation of reporting formats will bring disadvantage for banks that act on a national level only. Standardisation would increase their cost burden only. Possibly, the size of banks could become a decisive factor for a standardisation exercise.

#### - **The Internal Capital Adequacy Assessment Process:**

Re 27. Here the question comes up whether a standard approach (for part-portfolios) is sufficient, or what conditions are imposed with regard to the topic of "outsourcing"? The materiality limits to be taken account of should be clarified as well as the level between parent/subsidiary to be taken into consideration. What does it mean when it says "the institution may take into account risk correlations"? Since the "Strategic Plan" has to be prepared in a very comprehensive manner but is subject to constant changes, the question of periodicity is to be taken into account.

The document (re27 – XI b) encourages institutions to communicate more towards the market about their internal capital valuation process, in order for them to be able to establish comparison with their competitors. This principle would imply some disadvantages among which some relevance and confidentiality problems of issuing such information, taken also into account the quantity of information already issued in the scope of third pillar of Basel II.

#### - **Internal Capital Adequacy Assessment Process – ICAAP**

##### *II. The ICAAP is the responsibility of the institution*

It has to be noted that this principle gives a very wide discretion to the supervisors. Therefore it may turn out, in daily practice, to be extremely burdensome.

##### *III. ICAAP should be proportionate to the nature, size, risk profile and complexity of the institution*

It would be extremely important to put down the principles which part of the ICAAP can be outsourced. For small institutions this is an extremely important issue. It is highly doubtful that a small savings co-operative can comply with the requirement to treat all kinds of risks listed under Principle II. and under Principle VIII.



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A small institution, which is not able to measure credit risk, not even for internal purposes and therefore uses the regulatory standardised approach for internal capital assessment purposes, will not be able to approach all kinds of risks with special regard to risks which are very difficult to measure, e.g. reputational or strategic risks.

V-a “For the more sophisticated institutions, a complete integration of the ICAAP into day to day management is expected”

Risk measurement through capital requirement must obviously be part of a bank's management. However, capital is only one dimension in the bank's management with its value added but also its weaknesses. Regulators should be careful not to place this technique too high outshining all the others.

VI- “The ICAAP should be reviewed regularly”

It should be clarified that an annual review within the context of an annual audit of accounts will meet the requirements concerning a regular review by banks.

VII “The ICAAP should be risk-based”

The rationality of the bank's management may be presumed. We are afraid that such a request could imply quantifying what is mainly qualitative. We suggest to drop paragraph c. and to merge paragraph b and d.

VIII – The ICAAP should be comprehensive

We agree to the suggestions in principle. However, some issues need to be raised: As indicated above already, ICAAP should be limited to material risks only. We doubt that it is appropriate to create a category of risks as under VIII a ii, since they should be covered by VIII a i.

VIII – iv – c “There is no standard categorisation ...”, see annex B”

We agree to this principle, however the following issues need to be raised: The principle permits that the categorisation of risk would differ from the regulatory categories. However, it implicitly requires that the internal categories could be mapped to the regulatory ones. Does this mean that credit institutions are better to accept the categorisation of risk in Annex B? With special regard to the fact, that neither the risk of capital, nor that of earnings, is treated by risk management as special types of risks, because they are not considered as primary risks. The volatility of earnings and or the volatility of capital is due to the primary risk factors.

How should assess the impact on capital of such changes new accounting rules, EU and wider legislation, macro-economic factors, procyclicality. In the small institutions there is no professional knowledge to that. To assess the effects of these factors prove to be very difficult even for central banks. It is not realistic to expect that credit institutions of average size would be able to assess the impact of these factors with adequate professionalism.

When a risk is not quantifiable, it is not evident that supervisors can determine their materiality?



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VIII –iv-e “ ... there may be others which are more qualitative in nature. ...”

We recommend not elaborating on risks which are not yet “generally admitted” as such.

For example: Reputation Risk may already be captured as a combination of operational and business risks; besides capital may not be the right answer to reputation or strategic risk.

We believe that regulators should clearly recognise that diversification may exist and justify some capital reduction.

We have already outlined that “maintaining capital levels” may be inconsistent from the economic standpoint. We suggest adding the terms “appropriate to the risk profile”

VIII –g “ aggregation of risks”

The overwhelming majority of banks is currently not in a position to carry out a meaningful aggregation of risks. Hence, the objective of aggregating all material risks should be reserved for future bank control mechanisms.

X. The ICAAP should be based on adequate measurement and assessment processes

It is not clear that how a small association can it demonstrate that the standardised approach provides for an adequate capital cover for credit risk, if a small institution is not able to measure credit risk,. Equally, it remains unclear when a non-measurable risk is considered to be material and when it is immaterial. The notion may be different for bankers and supervisors.

XI. The ICAAP should produce a reasonable outcome

It is not exactly clear that how greater disclosure would solve the problem of the lack of comparison. The document is unclear on how institutions with a similar risk profile, which are supposed to form the peer groups for each other, can be compared by greater disclosure if their methodology and principles for ICAAP are entirely different.

XI b invites supervisors to encourage banks to make greater disclosures and to carry out peer benchmarks between their own ICAAP and the ICAAP of competitors. The specific ICAAP structure touches upon a highly sensitive area in terms of competition. Large areas of the ICAAP should however remain limited to a bilateral exchange between the bank and the supervisor.

**- Supervisory Review and Evaluation Process SREP**

Summary – 33 “broad disclosure on the Risk Assessment System (RAS) will contribute to the dialogue with institutions on their capital solution”

We suggest to keep out this last sentence or to define more clearly what is meant by “broad disclosure on the RAS”. We assume that such a disclosure is restricted to regulators and the bank concerned or only related to the methodology which underpins the process.

We understand and support the objective of a consolidated supervision. We would like to be sure that there is no supervisory overlapping, for example from the securities and insurance regulators.

Any regulatory request must be consistent with the accounting standards. A banking institution cannot have two sets of income statement.



Furthermore, the question of "superordinated" regulation needs to be solved ? It needs to be ascertained that there will not be a distortion of competition with other market players, e.g. financial service providers, which are not subject to these SREP provisions.

#### IV. The SREP should cover all material risks and risk management/internal controls

” At present, supervisors in the member countries use different rating systems, in order to support their work. It is unclear whether the RAS requires the substitution or the modification of these systems.

The standardisation and the transparency of the supervisory rating systems would be desirable and even if the categorisation of risks in Annex B can be debated, the standardisation of supervisory methodologies would be a very positive development.

#### V. The SREP shall assess and review the institution's ICAAP

Last sentence of point b) is not clear. It should be repeated that supervisors should not misuse the information included in the ICAAP and that additional capital charge should not be based on the simple increase of the confidence intervals.

#### VIII The SREP should lead to prudential measures and other supervisory actions being taken promptly to address any deficiencies identified according to Principle VII.

The list of measures presented under b) references measures, which could considerably interfere with a bank's business policy. However, interference with such business processes would not be backed by the rationale of the supervisory review process. It is therefore suggested to delete paragraphs (iv) and (iv).

#### Annex B: SREP business risks and control factors

The definition of interest rate risk and liquidity risk should be amended and should not make a reference to earnings:

- Proposal definition of Interest rate risk: *This is the current or prospective risk of a decline in the economic value arising from adverse movements in interest rates in the banking book.*

This definition is part of the document "Principles for the Management and the Supervision of Interest Rate Risk" published by the Basel Committee on the Banking Supervision on July 2004.

- Liquidity risk refers to an inadequate matching of maturities of assets and liabilities that could lead to the inability for the institution to meet its liabilities, in the context of a specific event other than the general market conditions, notwithstanding the recourse to sale of assets, securitisation, the repos market or any other form of transaction based on the creditworthiness of the assets rather than on the financial condition of the institution.

It seems important to notice that the liquidity risk, as defined in the annex B, couldn't be covered by a specific additional capital measurement. The liquidity risk is the result of a whole of others risks, and it's the associated capital to this whole of others risks that permits to an institution to have a high level of financial solidity protecting itself from the liquidity risk. The EACB members agree to measure the liquidity risk but not to take in account added capital.