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The voice of banking
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Draft guidelines for the joint assessment of the elements covered by the supervisory review and evaluation process and the joint decision regarding the capital adequacy of cross border groups (CEBS CP 39)

A response by the British Bankers' Association (BBA) and the Association for Financial Markets in Europe (AFME)

The BBA and AFME are pleased to respond to the consultation on the draft guidance for the joint assessment of the elements covered by the supervisory review and evaluation process and the joint decision regarding the capital adequacy of cross border groups. The industry supports supervisory cooperation and co-ordination for efficient supervisory oversight. In general firms consider that the draft CEBS guidelines and templates are a practical toolkit to facilitate the joint decision making process and a level playing field across borders and within colleges. We commend CEBS' desire to provide tools and structure for the comparison of information. Our response below draws out our discussion on the key issues. The annex to our letter contains our responses to the draft principles and guidance, and further observations.

We would welcome an approach that takes into account the nature, scale and complexity of firms, however we would like to reiterate the following eight key points:

Industry supports global colleges of supervisors: Our members support colleges of supervisors as they enhance the supervision of internationally active banks. Colleges need to operate in a way that optimises cooperation and streamlining of supervisory tasks. That optimisation needs to take account of the global, third country dimension, as well as within the EU/EEA. College arrangements need to be adaptable enough to enable global colleges in which EEA supervisors participate to work seamlessly with the EU college and its members, so that there is well-balanced and well-informed supervision of the group as a whole. In this context, it is important for CEBS guidelines to dovetail well with the Basel Committee's draft Good Practice Principles on Supervisory Colleges, published for consultation on 30th March. If appropriate, a "core" college should be established from the supervisors of materially significant operations. CEBS and its successor, the European Banking Authority (EBA), should work alongside the Basel Committee on Banking

Supervision (BCBS) and Financial Stability Board (FSB) to issue similar guidance at global level.

Role and powers of the EBA: We note that the European Commission's Omnibus Proposal, currently in codecision, foresees the possibility of technical standards on the operation of colleges, put forward by the proposed European Banking Authority (CEBS's planned successor), to be adopted by the European Commission, possibly as European Regulations, with binding effect. We consider that the detailed operation of colleges is a matter which involves a great deal of judgement and diplomacy, in particular, as noted above, where third countries are concerned. The level of detail of any technical standards in this area, and the extent to which they continue to allow flexibility for supervisory judgement will therefore be crucial. There is likely to continue to be a need for Level 3 Guidelines to guide judgemental aspects.

Legal entity vs Consolidated Group: It is important to recognise that firms may not align operations within jurisdictions or legal entities, as implied by the template structure. Firms are managed on along business lines and therefore supervision requirements which enforce duplication or double counting of capital should be avoided.

Modus operandi of the colleges of supervisors: We would like to reiterate our support for the colleges of supervisors and welcome CEBS placing colleges at the centre of proposals to enhance the regulation and supervision of cross-border banks. It is right that guidelines such as these for the operation of colleges are developed at not just the European level, but at global level too. Many of our members are subject to both "global" colleges and regional variants, most notably in the EU. We believe that it is in the interests of both financial institutions and their supervisors that these arrangements fit together as seamlessly as possible with the minimum of overlap.

There is a need for college arrangements to be flexible and to reflect the fact that no two groups are the same. This also means that there is an important role for CEBS, often in tandem with the Basel Committee or FSB, to play in identifying and promulgating examples of best practice. Colleges do not need to operate in the same way, but when individual colleges are particularly successful it is important that the reasons for this are understood and others have the opportunity to replicate the formula if desired.

We welcome the coordination of requests for information and the alignment of common reporting formats, requirements and deadlines, and for the submission of ICAAP reports being synchronised and their content aligned to ensure efficiency and avoid disruption. Colleges should first and foremost focus on coordinating and planning supervisory activities, but there should be a presumption that this should lead to the college members, under the auspices of the home supervisor, undertaking joint activities. Risk assessment, stress testing and model validation are all areas where joint work is important.

Communication between the college and senior management must not replace existing dialogues between the firm and local supervisors. It is essential to making the college process work effectively. We support the role of the consolidating supervisor as taking the lead in the college's activities, acting as the point of contact, and facilitating more efficient communication. Furthermore, the home supervisor should take responsibility for communication with the group and for coordinating requests for information. If host supervisors are unable to obtain relevant information from local management they should address requests for group level information to the home supervisor.

The willingness of supervisors to share information within the college is one of the key factors in determining their success. Financial institutions place the highest priority on the confidentiality of their data being preserved and therefore wish to see appropriate safeguards utilised to ensure information security. To help safeguard information security we would expect regulators and supervisors to apply best practice information risk management principles and processes around information which they receive via the colleges.

***Consistent use of templates between colleges**:* Common templates and criteria for assessments are welcome. These may need to become bespoke for each financial group. The formats and criteria should evolve and reflect the dynamism of business models.

A dividing line will need to be drawn in a way that carefully balances the need for consistent operation of colleges with the ability of the consolidating supervisor to exercise judgement. We would encourage CEBS to conduct a post implementation review across colleges to assess whether templates and criteria for assessment are consistently used and applied, although we appreciate that the former may need to be adapted to reflect the institution under review. CEBS should ensure that this is the case by monitoring and sharing best practice.

Materiality: The collation of information and subsequent discussion and review of the populated templates by the college should reflect the complexity of groups and the materiality of operations in each host state.

[1]***Stress testing***: We do not support CEBS repeating guidance on stress tests which is already referenced in CP 32. As per our response to CP 32, firms are concerned they could be subject to three levels of mandatory stress tests: compulsory tests determined by the institution's consolidating supervisor, tests required by the college of supervisors, and tests set by various national or regional authorities. This is in addition to in-house testing for risk management. A balance will need to be struck between testing undertaken by the firm to support the use test and the testing mandated by supervisors.

Transparency and feedback: Firms would welcome notification, in advance of college meetings to which they are invited, information on the work programme and likely data requests, to enable planning. Firms would also welcome fuller and timely feedback after college meetings on the outcome of the college. We would welcome guidance which explicitly references the need for two dialogue and transparency throughout the review process.

In conclusion, we welcome the guidance and objectives laid by CEBS for reaching a shared understanding of the capital adequacy of banking groups.

There are differences in the way that institutions understand the supervisory process in cross-border groups ie top-down vs bottom-up approaches for capital planning purposes which must continue to be recognised in supervisory assessments.

We hope that you will find our comments useful. Please contact us by way of e-mail Irving Henry and Adam Cull of the BBA (irving.henry@bba.org.uk and adam.cull@bba.org.uk) or Cristina Rabbini of AFME (Cristina.Rabbini@afme.eu) should you require further information.

Yours sincerely,

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[1] CEBS draft revised Guidelines on Technical Aspects of Stress Testing under the Supervisory Review Process

The British Bankers' Association ("BBA") is the leading association for UK banking and financial services sector, speaking for 220 banking members from 60 countries on a full range of UK and international banking issues. All the major institutions in the UK are members of our Association as are the large international EU banks, the US banks operating in the UK, as well as financial entities from around the world. The integrated nature of banking means that our members engage in activities ranging widely across the financial spectrum encompassing services and products as diverse as primary and secondary securities trading, insurance, investment bank and wealth management as well as conventional forms of banking.

AFME (Association for Financial Markets in Europe) was formed on November 1st 2009 following the merger of LIBA (the London Investment Banking Association) and the European operation of SIFMA (the Securities Industry and Financial Markets Association). AFME represents a broad array of European and global participants in the wholesale financial markets, and its 179 members comprise all pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. AFME participates in a global alliance with SIFMA in the US, and the Asian Securities Industry and Financial Markets Association through the GFMA (Global Financial Markets Association), and provides members with an effective and influential voice through which to communicate the industry standpoint on issues affecting the international, European, and UK capital markets. For more information please visit the AFME website, www.AFME.eu.

Annex

Detailed response to individual guidelines

Chapter 2: Individual assessments of risk and control factors performed in accordance with national practices and using Risk Assessment Systems

Guideline 1

We support the guidance and have no comments on the related paragraphs.

Guideline 2

We support the guidance and have no comments on the related paragraphs.

Guideline 3

We support the guideline 3. The phrase "suited to the characteristics of the group" is welcome. The nature, scale and complexity of the group should be one of the drivers of the college. If appropriate, third country supervisors should be present.

Element 1: We welcome the reference to materiality. This may have to be illustrated in guidance.

Element 2: There appears to be a conflation of issues. Income covers expected losses, but capital covers credit, market and operational risks.

Paragraph 36: It is unclear if guidance intends to refer to 'return on equity' when discussing 'adequate remuneration of the institutions return on capital'

Paragraph 38: Such discussions should remain strictly confidential as the information is market sensitive. Care will have to be taken when engaging with supervisors linked to banks, perhaps central banks which have stakes in (competitor) commercial banks.

Element 3: An understanding of risk appetite and strategy on the part of supervisors is welcome, but this engagement should be proportionate, i.e regular without being an imposition and conducted at management level rather than with front line staff.

Element 4: We welcome consideration of corporate governance. A sound governing system should be seen as an alternative to additional capital.

Paragraph 45: We welcome consideration of remuneration in the college system, including third countries where appropriate. This will enable management to maintain a unified approach, as far as possible, and avoid unnecessary duplication, for example in terms of disclosures.

Paragraph 46: An understanding of structure business model on the part of supervisors is welcome, but the dialogue should not lead to any prescription.

Paragraph 50: Any discussion of fit and proper persons should be strictly confidential. The subject should be given the right of reply.

Element 5, paragraph 53: Consideration of large exposures in the college system is welcome. Discussions should include the national differences in approach. For example, the Capital Requirements Directive (II) allows banks exposures up to 25% of own funds or EUR150m, whichever is the higher and without the need for waivers on a case by case basis. However, the UK's FSA has proposed limits of 100% of capital base or EUR100m, whichever is the higher and with waivers available on a case by case basis. The UK proposals thus impose credit and operational risks on banks operating there, especially the smaller ones, as they must increase the number of counterparties and amounts for deposit, and enables their overseas competitors to write more business.

Element 5, paragraph 54: Consideration of liquidity in the college system is welcome. Discussions should include the national differences in approach. For example, the FSA has imposed stricter rules than and ahead of its peers, and puts the host supervisor on a par with the home state regulator on liquidity matters. One impact is on the structure of the bank in the UK. The UK rules have the effect of steering banks towards subsidiarisation from branching.

Element 5, paragraph 55: We welcome alignment.

Guideline 4

Qualitative commentary, including from the firm, should accompany the scoring and have as much validity as figures.

Chapter 3: ICAAP framework assessments

Guideline 5

Qualitative commentary, including from the firm, should accompany the scoring and have as much validity as figures.

Guideline 6

In the event that the consolidating and host regulators are unable to reach an agreement, the lead regulator should have the final say.

Guideline 7

We welcome the references to proportionality, and nature, scale and complexity, however under paragraph 69 we would urge CEBS to consider stress testing as one of the pieces of the capital and liquidity planning, and risk management tools.

[2] CEBS issued draft guidance in December 2009. These were, or are, designed to assist institutions and supervisors in achieving outputs that are effective in identifying risks and their potential mitigants during times of stress and their impact on an institution.

We have identified that firms will be potentially subject to three levels of mandatory stress testing: compulsory tests determined by the institution's consolidating supervisor, tests required by the college of supervisors, and tests set by various national or regional authorities (manifested by firm versus supervisor testing, and group versus solo testing). A balance needs to be struck between testing undertaken by the firm to support the use test and the testing mandated by supervisors. Over emphasis on supervisor-mandated testing risks crowding firms' own risk management and potentially leads to double counting (which may lead to the trapping of capital and liquidity at solo level).

A globally consistent and co-ordinated regulatory approach is important to support the strengthening of global risk management practices. For example, coordination between local, regional and international authorities will avoid unnecessary duplication and reporting of stress tests. The college of supervisors, led by the consolidating supervisor,

[2] CEBS draft revised Guidelines on Technical Aspects of Stress Testing under the Supervisory Review Process

and with full firm engagement, will be key to this process. Stress testing methodologies and processes should be an important aspect of the college's discussions. Stress testing is an issue that extends beyond the EU boundary for many firms and coordination is essential to avoid duplication/unnecessary tests. Members would urge CEBS to seek ways to enhance cooperation with third country supervisors.

Stress testing is by nature a hypothetical forward-looking projection with margin of error. Care should be taken to avoid over reliance on stress test results and establishing direct links between stress test results and capital requirements. Testing should be seen as one of many factors informing management decision-making.

<u>Guideline 8</u>

We support the assertion that "it is the responsibility of the institution to choose how the group dimension is implemented in the ICAAP process". "Business lines may span different jurisdictions". We agree with this statement. It should also be noted that capital is allocated along business rather than jurisdictional lines.

<u>Guideline 9</u>

We agree that stress testing has a part to play in the capital planning process and that colleges are an ideal way to resolve issues such as the appropriate level to conduct tests, the number of tests to be conducted and the mitigating action taken.
We refer to the comments made further to Guideline 7.

<u>Guideline 10</u>

Under paragraph Paragraph 78 (b) we request further clarification on the meaning of the phrase "long term capital goal of the institution"

<u>Guideline 11</u>

In the event that the consolidating and host regulators are unable to reach an agreement, the lead supervisor should have the final word.

Qualitative commentary, including from the bank, should accompany the scores and have as much validity as the figures.

<u>Chapter 4: Minimum requirements of CRD including Pillar 1 and 3</u>

<u>Guideline 12</u>

Qualitative commentary, including from the firm, should accompany the scoring and have as much validity as figures. Further assessment, should explicity take account of compliance with the CRD minimum requirements in areas where there is scope for national discretion.

<u>Guideline 13</u>

We urge supervisors to adopt a proportionate approach when assessing compliance.

<u>Guideline 14</u>

In the event that the consolidating and host regulators are unable to reach an agreement, the lead supervisor should have the final word.

Chapter 5: Reconciliation of a firm and college of supervisors capital adequacy assessments

Paragraphs 97 (e) and 98: We welcome the statement that "prudential measures other than additional levels of own funds can more effectively address the identified deficiencies".

Guideline 15

Qualitative commentary, including from the bank, should accompany the scores and have as much validity as the figures.

Guideline 16

Supervisors should also consider the corporate governance and risk management alongside capital adequacy.

Guideline 17

Supervisors should understand the business model of the institution under review and its evolution.

Guideline 18

It should also be noted that capital is allocated along business rather than jurisdictional lines.

Guideline 19

Coordination between local, regional and international authorities is essential to help the sequencing of multiple supervisory stress tests, and avoid unnecessary duplicate testing and reporting, and the risk of crowding out in-house stress tests.

Guideline 20

Supervisors should get to know the business model of the institution under review and its evolution.

Guideline 21

We welcome alignment. However, in the event that the consolidating and host regulators are unable to reach an agreement, the lead supervisor should have the final word.

Guideline 22

Consideration should also be given to Basel's new definition of capital. We support EU alignment with BCBS.

Guideline 23

In the event that the consolidating and host supervisors are unable to reach an agreement, the lead regulator should have the final say. We welcome the proportionate approach (paragraph 126).