ABI Position Paper on the CEBS consultation paper: "The application of the supervisory review process under Pillar 2"

August 2004

- **Premise**

The Italian banking industry is grateful to the Committee of European Banking Supervisors (CEBS) for the chance to comment on the consultation paper on the Supervisory Review Process (SRP). This is a significant step forward in the creation of a common method for European supervisors.

Based on the observations of our member banks, ABI has drafted the attached position paper with comments, proposals and requests for clarification on the issues treated in the consultation paper.

- **Introduction**

The consultation paper does not clearly specify the scope of application of the Supervisory Review Process. The Italian banking industry accordingly requests that the CEBS provide an explicit indication thereof. It should be noted that Italian banks support application exclusively at consolidated or group level; application at sub-consolidated or solo bank level, it is felt, would entail problems of double counting of risks.

Equally, we feel that coordination between home and host country supervisors is an issue requiring further specification by the CEBS. The Italian banking industry holds that coordination should be the task of the home supervisor or, as it is sometimes called, the "consolidating supervisor".

- **Supervisory review process (SRP)**

On the first section of the consultation paper, Italian banks are glad to see that beyond the requirements of Pillar 1 it is considered important that supervisors make an overall evaluation of the banking group's capital and risk management strategy, imposing additional capital charges where this is held to be inadequate; conversely, the same principle should also mean that where the capital and risk management process is efficient, then the capital requirement should not be materially greater than the Pillar 1 minimum.

Paragraph 17 of the SRP document envisages one supervisory role as the imposition of additional capital charges, but no mention is made of the possibility of a downward adjustment.
We accordingly request that the Committee consider introducing a netting system to calculate3 the total capital charge where, under the Pillar 2 rules, there may be offsetting capital surpluses and shortfalls in different areas of business.
A negative capital adjustment in the framework of Pillar 2 is especially appropriate in cases where there is a high degree of portfolio diversification, one of the essential factors in determining the overall risk profile that Pillar 1 does not take into account.

- **The Internal Capital Adequacy Assessment Process (ICAAP)**

Italian banks are in broad agreement with the portion of the document concerning ICAAP. Yet there are a few points that we feel require modification or clarification on the part of the Committee.

Principle VIII. paragraph f: *Specifically regarding credit risk, the following should be taken into account: stress-testing in IRB, residual risk in CRM, concentration risk, securitisation etc.*

1. We think that as far as "residual risk" relating to credit risk mitigation techniques is concerned, on the one hand it could be treated as operational risk and on the other can be considered to be **a)** covered by haircuts under the Foundation approach and **b)** included within the estimates of LGD against exposures with guarantees. The Italian position is thus that save in exceptional cases no special attention or additional capital charge should be envisaged
2. As for concentration risk and securitizations, traditional or synthetic techniques of active portfolio management to reduce large exposures and optimize the portfolio should be explicitly considered as a plus for the institutions that use them.

Principle X. paragraph c (iii): *as a more sophisticated and complex system, possibly using "bottom-up" transaction-based approaches with integrated correlations.*

We would like to see the CEBS provide a detailed clarification on the method proposed here, with examples as in point (i) of this paragraph, as the process for banks to evaluate risks, insofar as the "bottom-up" approach is not self-explanatory or readily comprehensible.

Principle XI. paragraph b*: Institutions might be encouraged to make greater disclosures, in order to allow them (and others) to make a comparison, for their internal purposes, of their ICAAP within their peer group, and in order to have a basis for comparison and a reasonableness check.*

Italian banks have some concerns regarding Principle XI. We hold that Pillar 2 should be considered, in its entirety, as a confidential process, not subject to disclosure even to the peer group, and that it should act as a stimulus for banks to development different risk measurement and management techniques.

- **Supervisory Review Evaluation Process**

We welcome ***Principle I. paragraph d,*** namely the affirmation "*However, the European authorities agree that while flexibility of approach is important, there will need to be common minimum standards or benchmarks in order to ensure consistency of application and a level playing field across Europe*."
The Italian banking system considers it essential to take a flexible approach and at the same time strongly endorses the explicit statement of intention to create a level playing field in Europe.